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No. 06-

IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. and MOTOROLA, INC.,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether this Court's decision in *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994), forecloses claims for deceptive conduct under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5(a) and (c), 17 C.F.R. 240.10b-5(a) and (c), where Respondents engaged in transactions with a public corporation with no legitimate business or economic purpose except to inflate artificially the public corporation's financial statements, but where Respondents themselves made no public statements concerning those transactions.

CORPORATE DISCLOSURE STATEMENT

Petitioner Stoneridge Investment Partners LLC is not a subsidiary of any other corporation and no publicly held corporation owns 10% or more of its stock.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-11a) is reported at 443 F.3d 987 (8th Cir. 2006). The final judgment of the district court (Pet. App. 12a-14a) is unreported. The district court's memorandum and order (Pet. App. 15a-29a) is unofficially reported at 2004 U.S. Dist. LEXIS 29679, 2004 WL 3826760 (E.D. Mo. Dec. 20, 2004). The district court's memorandum and order (Pet. App. 30a-71a) is unofficially reported at 2004 U.S. Dist. LEXIS 29647, 2004 WL 3826761 (E.D. Mo. Oct. 12, 2004).

STATEMENT OF JURISDICTION

The judgment of the court of appeals was entered on April 11, 2006. This Court has jurisdiction under 28 U.S.C. § 1245(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), states as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention

of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

* * *

Rule 10b-5, 17 C.F.R. 240.10b-5, states as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> > (a) To employ any device, scheme, or artifice to defraud,
> >
> > (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> >
> > (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

STATEMENT OF THE CASE

This is a class action brought on behalf of purchasers of the securities of Charter Communications, Inc. ("Charter") for violations of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and Rule 10b-5, 17 C.F.R. § 240.10b-5.

Respondents Scientific-Atlanta, Inc. ("Scientific-Atlanta") and Motorola, Inc. ("Motorola") (collectively, "Respondents"), are alleged to be primary violators of Rule 10b-5(a) and (c) in engaging in a scheme with Charter for the sole purpose of portraying a false picture of Charter's financial performance. This scheme with Respondents was the subject of an indictment by the United States Department of Justice ("DOJ") against two of Charter's officers, as well as a Cease and Desist Order procured by the Securities and Exchange Commission ("SEC") against Charter.

The court of appeals affirmed the district court's dismissal of the claims against Respondents, holding that they were barred by this Court's decision in *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994). The claims against all defendants other than Respondents were settled.

Charter is one of the country's largest cable television providers. It announced its operating results and projections on a quarterly basis in press releases and conference calls with cable industry stock analysts. Its executives and employees also regularly communicated with stock analysts regarding such information. Two of the primary indicators upon which these analysts relied when evaluating the value of Charter's stock were operating cash flow and revenue. Charter's management viewed success in meeting stock analysts' expectations as critical to determining its stock price.

In or about August 2000, Charter realized that its 2000 year-end operating cash flow would be lower than the amount both

it and its stock analysts had projected. In an effort to generate the $15-20 million in additional revenue needed to meet these critical cash flow projections, Charter directed one of its executives to solicit advertising business from Respondents, who are Charter's largest suppliers of set-top boxes. (Charter's subscribers use set-top boxes to receive television signals.) Respondents rebuffed these solicitations, however. In recognition of the negative impact that a disappointment in meeting analysts' estimates would have on the price of Charter's stock, Charter requested that Respondents enter into a scheme with it which would falsely inflate Charter's publicly reported year-end revenue and operating cash flow in order to artificially inflate Charter's stock price. The simplicity of the scheme was trumped only by its brazenness.

Charter agreed to offer funds to Respondents who would use these funds to purchase advertising from Charter but at no cost to Respondents. Charter offered Respondents an additional $20 for each set-top box that Charter purchased, if Respondents would agree to return that money to Charter by buying advertising in an equivalent dollar amount. No revenue would be justifiably earned because Charter was using its own funds so that Respondents could "purchase" the advertising. The result would be of no real economic benefit to Charter or Respondents. The sole purpose of the scheme was to perpetuate a fraud by artificially increasing Charter's revenue and operating cash flow.

With respect to Respondent Scientific-Atlanta, Charter had in place long-term contracts to purchase set-top boxes at fixed prices. These contracts were entered into in December 1999 and were modified in July 2000. Nonetheless, at Charter's request, Scientific-Atlanta agreed to claim falsely that it was increasing the price of each box by $20 and that it

would return that money to Charter by supposedly buying needed advertising from it.

To give some appearance of legitimacy to the supposed price increase, on August 28, 2000, a Charter senior executive instructed Scientific-Atlanta's Managing Director for North American Sales to fabricate a letter informing Charter that Scientific-Atlanta was raising set-top box prices. Charter emailed Scientific-Atlanta that the "pricing increase notification letter" should include:

> 1. The reason for the price increase and the date (09/01/00) of the increase.
>
> 2. A description of the quantities of set-tops this letter would cover, the anticipated number of set-tops (351,180) that SA [Scientific-Atlanta] expects to ship and Charter expects to take delivery of between 09/01/00 and 12/31/00.
>
> 3. A penalty provision in case Charter doesn't accept the anticipated number of set-tops in the specified time frame.

To round out the scheme, Charter's senior executive also said, "In addition, I will be sending the advertising contract for review prior to the final particulars being worked out."

Immediately after sending these instructions to Scientific-Atlanta, Charter's Vice-President of Advertising Sales was directed to prepare an advertising contract with Scientific-Atlanta worth nearly $6.73 million, the exact amount of the phoney price increase for the set-top boxes.

In accordance with the scheme, on August 31, 2000, Scientific-Atlanta's National Business Manager notified Charter that Scientific-Atlanta was increasing the price for

all set-top boxes scheduled to be purchased by Charter for the balance of 2000. Scientific-Atlanta falsely attributed the price change to "increased manufacturing costs."

The amended contract for the price increase was finalized in late September. Also in late September 2000, Scientific-Atlanta and Charter executed "marketing support" agreements entitled: "Spot Telecasting and Digital Marketing Support Fee Agreements." These agreements set rates in the exact amount necessary to funnel back to Charter the millions of dollars that Charter had agreed to pay for the sham price increase, *i.e.*, Charter agreed to pay $6.73 million more for the boxes than it had previously contracted for and Scientific-Atlanta agreed to pay exactly that same amount for advertising. Moreover, the rates for the advertising were four to five times the amounts ordinarily charged, further indicative of the lack of any genuine business purpose to the transactions.

As noted, the set-top box contract and the advertising contract were not finalized until late September. Nonetheless, to give the appearance that the contracts were not related, Scientific-Atlanta agreed to allow the set-top box contract to be back- dated to August.

With respect to Respondent Motorola, Charter had agreements in place to purchase a stated number of set-top boxes at established prices. In late September, however, Charter finalized a contract to purchase 540,000 "cable set-top boxes" by the end of the year. The size of the order was extraordinary considering that Charter had already contracted to purchase this same number of boxes for the entire twelve months of 2001.

Most significantly, Charter agreed to pay Motorola $20 "liquidated damages" for each unit that it defaulted on buying during the fourth quarter of 2000. In turn, Motorola agreed by contract dated September 29, 2000 to purchase advertising from Charter that it did not need and at inflated rates which totaled $10,800,000, the exact amount of the "liquidated damages" for the 540,000 boxes. As with Scientific-Atlanta, although the new contract to purchase the set-top boxes was not finalized until late September, Motorola agreed to back-date the contract for the set-top boxes to give the false appearance that the contracts were unrelated.

The $17 million in revenue to Charter from these schemes with Respondents was the exact amount Charter needed to cover the shortfall in its true financial results and the results its securities analysts were expecting.

The fraudulent nature of these transactions is aptly summarized by the SECs July 27, 2004 Cease and Desist Order against Charter:

> In reality, no real revenue was generated from these transactions because Charter provided the suppliers with the money they used to purchase the advertising services from Charter. Charter *overpaid* approximately $17 million to the two set-top suppliers and received the same amount back from the two suppliers as advertising revenue in the fourth quarter of 2000. . . .

Respondents understood that pursuant to the scheme, the so-called advertising revenue received from them was to be included in Charter's revenues and operating cash flow for the year 2000. Charter's financial statements containing these fraudulent transactions were distributed to the investing public and filed with the SEC.

Petitioners allege that Respondents violated § 10(b) and Rule 10b-5(a) and (c) by participating in a "scheme or artifice to defraud" and by engaging in a "course of business which operates . . . as a fraud or deceit."

The district court dismissed the claims against Respondent, holding that they were not primary violators of § 10b and Rule 10b-5 as Petitioners had alleged, but rather were aiders and abettors of Charter in its violation of § 10(b). Accordingly, the district court held that the claims against Respondents were barred by this Court's holding in *Central Bank*. The court also denied Petitioners' motion to amend the complaint to plead additional facts on the ground that it would be futile since it was based on the same legal claim which the court found unsustainable.

The court of appeals affirmed the dismissal, ruling that Petitioners' claims were barred by this Court's decision in *Central Bank*, holding that "[a] device or contrivance is not 'deceptive' within the meaning of § 10(b) absent some misstatement or a failure to disclose by one who has a duty to disclose." 443 F.3d at 992. It concluded that absent such a statement or failure to disclose, Respondents' conduct amounted to that merely of aiders and abettors, and that "[t]o impose liability for securities fraud on one party to an arm's length business transaction in goods and services other than securities because that party knew or should have known that the other party would use the transactions to mislead investors in its stock would introduce potential far reaching duties and uncertainties" for such parties. *Id.* at 992-93.

REASONS FOR GRANTING THE PETITION

This Court has consistently recognized that Congress designed § 10(b) of the Securities Exchange Act to prohibit all fraudulent schemes in connection with the purchase or sale of securities, no matter how novel, unique or cunning. The court of appeals committed error by limiting the reach of 10(b) only to certain manipulative securities trading or false and misleading statements. The court of appeals' reliance on *Central Bank* for its holding was misplaced. In *Central Bank* this Court held that there is no private right of action under § 10(b) for those who merely aid and abet a securities fraud by someone else unless they themselves also engaged in fraudulent conduct, since the text of the statute only encompasses fraudulent conduct. But nothing in *Central Bank* changed the prohibition in § 10(b) or Rule 10b-5(a) and (c) concerning "*any*" deceptive conduct.

Whether *Central Bank* altered a long line of decisions in this Court as to the nature of "deceptive" practices captured by § 10(b) is an issue pending in various courts around the country in major securities litigations. Contrary to the decision by the court of appeals in this proceeding, in many of these cases district courts have upheld claims for deception other than the issuance of false and misleading statements. Other courts' decisions are consistent with the court of appeals.

These major securities fraud litigations involve billions of dollars in claims. Consequently, certainty by this Court as to the full reach of § 10(b) is of paramount importance. Without it, whether victims of a fraud may obtain compensation for injuries caused by egregious misconduct depends completely on the forum, and not on the statutory text or this Court's established precedents.

In "'an area that demands certainty and predictability,'" *Central Bank*, 511 U.S. at 188 (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)), there is instead disarray. It is critically important that this Court grant review to provide the needed certainty.

A. The Court of Appeals Disregarded the Statutory Text, Congressional Intent, and Misapplied Long-Established Precedents of this Court

In determining the scope of § 10(b), this Court has instructed that the text is controlling. As stated in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976): "[W]e turn first to the language of § 10(b), for '[t]he starting point in every case involving construction of a statute is the language itself.'" (citation omitted.) *See also Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 472 (1977).

Under § 10(b), *"any person, directly or indirectly"* is prohibited from using *"any manipulative or deceptive device or contrivance* in contravention of such rules and regulations as the [SEC] may prescribe." 15 U.S.C. § 78j(b) (emphasis added). Rule 10b-5, promulgated by the SEC, directed against "any person" who engages in broadly described misconduct, provides, in relevant part:

> It shall be unlawful for any person, directly or indirectly . . .
>
> > (a) To employ *any device, scheme or artifice to defraud,*
> >
> > (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

> (c) *To engage in any act, practice, or course of business which* operates or would operate as a fraud or deceit upon any person. . . .

17 C.F.R. § 240.10b-5 (emphasis added).

This Court has consistently found that "[t]he scope of Rule 10b-5 is coextensive with the coverage of § 10(b)." *SEC v. Zandford*, 535 U.S. 813, 1901 n.1 (2002) (citations omitted); *see also Central Bank*, 511 U.S. at 172 (Rule 10b-5 "casts the proscription in similar terms" as § 10(b)); *Ernst & Ernst*, 425 U.S. at 214. The Court has specifically concluded that while Rule 10b-5 liability is premised on the "making of an untrue statement of material fact and the omission of a material fact," subsections (a) and (c) "are not so restricted." *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 152-53 (1972). Indeed, the "repeated use of the word 'any'" in the statement and the rule is "obviously meant to be inclusive." *Id.* at 151. If the only cognizable deceptive conduct were false statements, as the court of appeals held, Rule 10b-5(a) and (c) would be entirely superfluous.

In *Ernst & Ernst*, this Court emphasized that the words used in § 10(b) must be given their "commonly accepted meaning." 425 U.S. at 199. In this regard, this Court invoked the dictionary definitions of "device" and "contrivance":

> Webster's International Dictionary (2d ed. 1934) defines "device" as "[t]hat which is devised, or formed by design; a contrivance; an invention; project; scheme; often, a scheme to deceive; a stratagem; an artifice," and "contrivance" in pertinent part as "[a] thing contrived or used in contriving; a scheme, plan, or artifice." In turn, "contrive" in pertinent part is defined as "[t]o

> devise; to plan; to plot . . . [t]o fabricate . . . design; invent . . . to scheme. . . ."

Id. at 199 n.20 (alterations and omissions in the original). These definitions are broad and inconsistent with a limitation of liability relating only to misleading statements and omissions as the court of appeals held in this case. Significantly, in *Ernst & Ernst*, this Court acknowledged that subsections (b) and (c) of Rule 10b-5 can be read as "proscribing . . . any type of material misstatements or omission, *and any course of conduct*, that has the effect of defrauding investors." 425 U.S. at 212 (emphasis added). Section 10(b) is "a 'catchall' clause to enable the Commission 'to deal with new manipulative [or cunning] devices.'" *Id.* at 203. *See also Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971) (cause of action under § 10(b) and Rule 10b-5 exists where defendants engaged in a fraudulent scheme whereby they misappropriated the proceeds of a corporation's sale of treasury bonds so that one defendant could use those proceeds to pay for all the shares of the same corporation that he had recently purchased).

In again addressing "the reach and coverage of § 10(b)" in *Santa Fe Industries*, 430 U.S. at 464, this Court made it clear that § 10(b) and Rule 10b-5 covered "*deception*, misrepresentation or nondisclosure." *Id.* at 1302 (emphasis added). It found that deception was not limited to misrepresentation or nondisclosure, since it stated the issue in the disjunctive. Indeed, the Court repeatedly focused on "deceptive conduct" as the *sine qua non* of a claim under § 10(b) and Rule 10b-5 rather than merely misleading statements or omissions. *Id.* at 475 n.15. Nevertheless, the court of appeals cited to *Santa Fe Industries* as supporting its narrow interpretation that only false statements are deceptive under the statute.

As this Court has stated: "'We believe that § 10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws.'" *Superintendent of Ins.*, 404 U.S. at 10 n.7 (quoting *A.T. Brody & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967)). Congress' intent was to "'insure honest securities markets and thereby promote investor confidence,'" *Zandford*, 535 U.S. at 821 (quoting *United States v. O'Hagan*, 521 U.S. 642, 658 (1977)), as well as to "'achieve a high standard of business ethics in the securities industry.'" *Id.* (quoting *Affiliated Ute Citizens*, 406 U.S. at 151. Thus, § 10(b) is "read flexibly, not technically and restrictively." *Superintendent of Ins.*, 404 U.S. at 12. Indeed, the legislative history reveals Congress' intent to include within § 10(b)'s proscription the very type of conduct implicated here: "the [Senate] Report . . . reveals . . . an overall congressional intent to prevent 'manipulative and deceptive practices which . . . *fulfill no useful function*' and to create private actions for damages stemming from *'illicit practices,'* where the defendant has not acted in good faith." *Ernst & Ernst*, 425 U.S. at 206 (citing to S. Rep. No. 792, 73rd Cong., 2d Sess., at 6 (1934)) (emphasis added); *see also Santa Fe Industries*, 430 U.S. at 473 n.13.

Here, Respondents are alleged to have intentionally engaged in illicit wash or sham transactions, which served "no useful" or legitimate function, for the sole purpose of falsifying Charter's publicly reported financial results. They worked as Charter's partners in the fraudulent scheme to deceive investors and knowingly engaged in acts which were themselves fraudulent. Their illicit acts were inextricably connected to the false statements issued by Charter and were

among the key foundations of one unified fraudulent scheme. Most certainly, Respondents' conduct fits into the "commonly accepted meaning" of the "deceptive device or contrivance" language of § 10(b).

The court of appeals' ruling is not only contradicted by the text of § 10(b) and Rule 10b-5 and this Court's precedents, but is also entirely inconsistent with the legislative intent and history of the statutory scheme.

1. The Court of Appeals Misapplied *Central Bank*

In *Central Bank*, contrary to the ruling of the court of appeals, this Court did not limit the deception prong of § 10(b) to misstatements and omissions. *Central Bank* foreclosed the availability of aiding and abetting liability, but did not decide the full scope of misconduct that creates primary liability. It certainly did not address whether a primary violation can arise from a defendant's engagement in a deceptive scheme or course of conduct under Rule 10b-5(a) and (c), since that issue was not then before the Court.

In *Central Bank*, the plaintiffs had conceded that the defendant did not commit a manipulative or deceptive act, but only assisted another's fraud by failing to insist on the updating of an appraisal that would have revealed the fraud. 511 U.S. at 191-92. Thus, the only issue the Court faced was "the existence and scope of the § 10(b) aiding and abetting action," *id.* at 170, or in other words, whether § 10(b) reached those "who do not engage in the proscribed activities at all, but who give a degree of aid to those who do." *Id.* at 176. It emphasized that "[i]n any complex securities fraud, . . . there are likely to be multiple [primary] violators," and strongly cautioned that "[t]he absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability." *Id.* at 191. They can

be liable "when *all* the requirements for primary liability under Rule 10b-5 are met." *Id.* (emphasis in the original). The Court did not address, far less restrict, the definition of primary liability.

The court of appeals pegged its ruling to a passing reference in *Central Bank* that § 10(b) "prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act." 511 U.S. at 177. In this *dictum*, the Court did not itemize the full range of acts sufficient to establish primary liability under § 10b-5, since it was addressing conduct self-described by plaintiff as aiding and abetting. It is hardly likely that this Court intended by this statement to abandon the long line of cases discussed above where it recognized the reach of § 10(b) to capture *any* fraudulent act — not merely misstatements. The issue was not before the Court, the parties had not briefed the scope of primary liability, and the courts below had not addressed it. The Court had no reason to address, far less decide, whether the deception prong of § 10(b) only prohibits misstatements or omissions.

Indeed, when this Court's *dictum* is taken in context, it hardly supports the court of appeals' reading of it:

> [W]e again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act. *See Santa Fe Industries*, 430 U.S. at 473 ("language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception"); *Ernst & Ernst*, 425 U.S. at 214 ("When a statute speaks so specifically in terms of manipulation and deception . . . we are quite unwilling to extend the

> scope of the statute"). The proscription does not include giving aid to a person who commits a manipulative or deceptive act. We cannot amend the statute to create liability *for acts that are not themselves manipulative or deceptive* within the meaning of the statute.

Central Bank, 511 U.S. at 177-78 (emphasis added). Thus, just after the *dictum*, this Court cited to two precedents which, as described above, apply the "commonly accepted meaning" of "deceptive device or contrivance," rely on a broad definition, *Ernst & Ernst*, 425 U.S. at 199, and construe that language to prohibit "any *deception*, misrepresentation, or nondisclosure," not just misleading statements or omissions, *Santa Fe Industries*, 430 U.S. at 476 (emphasis added). Significantly, the Court expressly limited its analysis to acts that the parties conceded to be "not themselves manipulative or deceptive," the exact opposite of the situation here. *See* 511 U.S. at 174, 178.

The other cases relied upon by the court of appeals involved claims under Rule 10b-5(b) for misstatements and are inapplicable here. As this Court stated in *Affiliated Ute Citizens*, while Rule 10b-5(b) liability is premised on the "making of an untrue statement of a material fact and the omission to state a material fact," subsections (a) and (c) "are not so restricted." 406 U.S. at 152-53. Similarly, as noted in *In re Parmalat Sec. Litig.* 376 F. Supp. 2d 472, 499 (S.D.N.Y. 2005): "This [misstatement] attribution rule defines the contours of liability for violations of Rule 10b-5(b)" but not the reach of subsections (a) and (c). *See also In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 335-36 (S.D.N.Y. 2004) ("[I]n attempting to reduce plaintiffs' arguments to a mere theory of 'fraudulent statement by another name,' [the auditor] itself conflates the distinct

elements of a claim for false statements under subsection (b) of Rule 10b-5 with those of a claim for engaging in fraudulent scheme under subsections (a) or (c)."); *In re Enron Corp. Sec. Derivative & "ERISA" Litig.*, MDL-1446, Civ. A. No. H-01-3624, 2006 U.S. Dist. LEXIS 43146, at *91-*92 (S.D. Tex. June 5, 2006) ("*Enron III*"); *In re Enron Corp. Sec. Derivative & "ERISA" Litig.*, 235 F. Supp. 2d 549, 577 (S.D. Tex. 2002) ("*Enron I*").

2. The Court of Appeals Disregarded this Court's Post-*Central Bank* Ruling Reaffirming the Broad Reach of Section 10(b)

SEC v. Zandford, 535 U.S. 813, decided eight years after *Central Bank*, also makes clear that the ruling of the court of appeals is inconsistent with the text of § 10(b) and Rule 10b-5. In *Zandford*, this Court addressed claims under Rule 10b-5(a) and (c) involving a stock broker's sale of customers' securities and use of such proceeds for his own benefit without the customers' knowledge. The Court was not troubled by the fact that the defendant did not make any misstatement. *Id.* at 822. It ruled: "Indeed, each time respondent 'exercised his power of disposition [of his customers' securities] for his own benefit,' *that conduct*, '*without more*,' was a fraud." *Id.* at 821 (emphasis added) (citation omitted). The Court further stressed that "neither the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security in order to run afoul of the Act." *Id.* at 820. The Court also reiterated that "the statute should be 'construed not technically and restrictively, but flexibly to effectuate its remedial purposes.'" *Id.* at 819 (citation omitted).

Here, Respondents' deceptive acts represented a "threat to investor confidence in the securities industry," just as much as a misstatement or omission would. *See Zandford*, 535 U.S. at 822.

B. Lower Courts from a Number of Circuits Have Followed the Statutory Text and this Court's Precedents in Acknowledging the Viability of Scheme Liability

Lower courts have recently upheld primary violations of § 10b and Rule 10b-5(a) and (c), for conduct that the court of appeals held not actionable. *See Enron III*, U.S. Dist. LEXIS 43146, at *156-*74; *SEC v. Hopper*, Civ. A. No. H-04-1054, 2006 U.S. Dist. LEXIS 17772, at *36-*40, 2006 WL 778640, at *11 (S.D. Tex. Mar. 24, 2006); *Parmalat*, 376 F. Supp. 2d at 472; *Quaak v. Dexia, S.A.*, 357 F. Supp. 2d 330 (D. Mass. 2005), *appeal dismissed*, No. 05-2580 (1st Cir. Mar. 29, 2006); *In re Enron Corp. Sec. Derivative & "ERISA" Litig.*, 310 F. Supp. 2d 819 (S.D. Tex. 2004) ("*Enron II*"); *Global Crossing*, 322 F. Supp. 2d at 336-37; *In re AOL Time Warner Sec. & "ERISA" Litig.*, 381 F. Supp. 2d 192, 217 (S.D.N.Y. 2004); *In re Lernout & Hauspie Sec. Litig.*, 236 F. Supp. 2d 161 (D. Mass. 2003); *Enron I*, 235 F. Supp. 2d at 577. Consistent with this Court's teaching in *Affiliated Ute Citizens*, 406 U.S. at 152-53, these courts found that the misrepresentation and omission proscription contained in Rule 10b-5(b) should not be confused with the scheme and course of conduct liability based on the deception prong of Section 10(b) and the express language of Rule 10b-5(a) and (c). *Cf. In re Homestore.com, Inc. Sec. Litig.*, 252 F. Supp. 2d 1018 (C.D. Cal. 2003), *appeal docketed*, No. 04-55665 (9th Cir. Apr. 16, 2004).

The courts that have recognized the claims under Rule 10b-5(a) and (c) have properly followed the text of § 10b and this Court's precedents and found that deception means more than merely misrepresentations and omissions, but includes a scheme or course of conduct to defraud investors through sham transactions solely designed for the fabrication

of financial statements, even where the defendant itself is not charged with the issuance of the misleading statement or with any duty to disclose facts. For example, in *Parmalat*, the defendant banks were not charged with any misstatements or omissions, or "classic market manipulation." 376 F. Supp. 2d at 492. Instead, their liability was based on their use of fraudulent transactions, *i.e.*, their securitization and factoring of worthless Parmalat invoices which were misreported in Parmalat's statements. *Id.* at 504. In holding that plaintiff had alleged a primary violation of Section 10(b), the court was guided by this Court's broad "instruction on the meaning of the relevant terms in Section 10(b)," i.e., "deceptive device or contrivance," provided in *Ernst & Ernst*. *Id.* at 502 n.151-52. The *Parmalat* court further agreed with the ruling in *Lernout & Hauspie*:

> [T]he better reading of § 10(b) and Rule 10b-5 is that they impose primary liability on any person who substantially participates in a manipulative or deceptive scheme by directly or indirectly employing a manipulative or deceptive device (*like the creation or financing of a sham entity*) intended to mislead investors, even if a material misstatement by another person creates the nexus between the scheme and the securities market.

Id. at 502 (quoting *Lernout & Hauspie*, 236 F. Supp. 2d at 173 (emphasis added)). The court in *Parmalat* adopted this formulation, except for the reference to "substantial participation," explaining that "[t]he text asks only whether a defendant directly or indirectly used or employed a manipulative or deceptive device or contrivance." *Id.* at 503 (footnote omitted).

This is the same conclusion drawn in *Enron I*, *Enron II*, *Enron III*, *Hopper*, *Quaak*, *Global Crossing*, and *AOL Time Warner*. For example, the court in *Enron I* concluded, relying on *Ernst & Ernst* and *Affiliated Ute Citizens*:

> Securities fraud actions under § 10(b) and Rule 10b-5 *are not merely limited to the making of an untrue statement of material fact or omission to state a material fact*. Section 10(b) prohibits "any manipulative or deceptive contrivance," which, as indicated above, the Supreme Court, relying on *Webster's International Dictionary*, includes "a scheme to deceive" or "scheme, plan or artifice." *Ernst & Ernst*, 425 U.S. at 199 n.20. While subsection (b) of Rule 10b-5 provides a cause of action based on the "making of an untrue statement of a material fact and the omission to state a material fact," subsections (a) and (c) "are not so restricted" and allow suit against defendants who, with scienter, participated in "a 'course of business' or a 'device, scheme or artifice' that operated as a fraud" on sellers or purchasers of stock *even if these defendants did not make a materially false or misleading statement or omission. Affiliated Ute Citizens v. United States*, 406 U.S. 128, 152-53 (1972).

235 F. Supp. 2d at 577 (emphasis added). Just last month, in *Enron III*, the court rejected the court of appeals' holding, and reaffirmed its prior rulings in *Enron I* and *Enron II*. *See Enron III*, 2006 U.S. Dist. LEXIS 43146, at *173-*174.

C. Scheme Liability is Not Implicated by Arm's Length Transactions

The court of appeals expressed concern in imposing scheme liability on parties engaged in "an arm's length non-securities transaction . . . [where Charter] then used the transaction to publish false and misleading statements. . . ." 443 F.3d at 992-93. But Petitioners made no such claim. Respondents are charged with deliberately participating in a fraudulent scheme and themselves performing such fraudulent acts as back-dating its contracts with Charter. The challenged transactions were not at arm's length, had no valid business or any other legitimate purpose, and were absolute shams transactions. In sum, Respondents themselves engaged in acts that were deceptive and which conduct was inextricably connected to the deception of Charter's investors.

In *Parmalat*, 376 F. Supp. 2d at 492, the defendant banks argued that they merely entered into lawful business deals with a customer, who in turn improperly accounted for the transactions in its financial statements. Therefore, the defendant banks argued, they were at most aiders and abettors. In rejecting this argument, the court emphasized:

> The transactions in which the defendants engaged *were by nature deceptive*. They depended on a *fiction*, namely that the invoices had value. *It is impossible to separate the deceptive nature of the transactions from the deception actually practiced upon Parmalat's investors*. Neither the statute nor the rule requires such a distinction.

376 F. Supp. 2d at 504 (emphasis added). The court further explained that the banks' "regular factoring and securitization of worthless invoices were deceptive devices or contrivances for purposes of Section 10(b). *These were inventions, projects,*

or schemes with the tendency to deceive because they created the appearance of a conventional factoring or securitization operation when, in fact, the reality was quite different." *Id.* (emphasis added). It also pointed out repeatedly that the plaintiff in *Central Bank* had conceded that the defendant had not itself committed a deceptive (or manipulative) act, and "there is nothing in the decision to suggest that *Central Bank* would have escaped liability if it had been found to have committed such an act." *Id.* at 499. It also underscored that the *Central Bank* "decision did not affect the contours of a primary violation of Section 10(b)." *Id.* at 499. *See also SEC v. Hopper*, 2006 U.S. Dist. LEXIS 17772, at *39, 2006 WL 778640, at *11 (The alleged round trip trading scheme in which defendant was involved, included "sham transactions, and therefore had an inherent tendency to deceive" and could constitute "a 'device' or 'scheme' to defraud, or at least a 'practice' or 'course of business' which operated as a fraud or deceit upon the investing public, that encompassed conduct beyond mere misstatements."); *Global Crossing*, 322 F. Supp. 2d at 336-37 ("Schemes used to artificially inflate the price of stocks by creating phantom revenue fall squarely within both the language of section 10(b) and its broad purpose. . . ."); *Enron II*, 310 F. Supp. 2d at 829 ("[A] misrepresentation need not have been made because the statute also applies to conduct, here the alleged substantial, active role *in major fraudulent transactions with no legitimate business purpose*, but designed to deceive investors in and central to a scheme and course of business operating to present a falsely inflated image of Enron's financial strength.") (emphasis added).[1]

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1. The court in *Enron II* also further explained:

> Sham business transactions with no legitimate business purpose that are actually guaranteed "loans" employed

(Cont'd)

The SEC has proposed the following simple test to separate out aiding and abetting conduct from a primary violation:

> Any person who directly or indirectly engages in a manipulative or deceptive act as part of a scheme to defraud can be a primary violator of Section 10(b) and Rule 10b-5(a); any person who provides assistance to other participants in a scheme but does not himself engage in a manipulative or deceptive act can only be an aider and abettor.

Brief of the Securities and Exchange Commission, *Amicus Curiae*, in Support of Positions That Favor Appellant, *Simpson v. Homestore.com, Inc.*, No. 04-55665 (9th Cir. served Oct. 21, 2004 and filed Oct. 22, 2004), at 16, *also available at* http://www.sec.gov/litigation/briefs/ homestore_ 102104.pdf. The SEC has also provided numerous helpful examples as to how a primary violation can be distinguished from aiding and abetting. If a bank loans money to a person knowing that he will use the loan proceeds to commit securities fraud, the bank's conduct — which is otherwise not manipulative or deceptive — constitutes merely aiding and abetting. This is also true of a third party who enters into a legitimate transaction with a company, knowing that the company will inflate the revenues created by that transaction. A primary violation, however, can be implicated

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(Cont'd)

> to inflate Enron financial image are not above-board business practices. This Court disagrees with Merrill Lynch's contention that the alleged "'deception' did not occur until Enron allegedly misreported" the transactions.

310 F. Supp. 2d at 830.

if the third party and company engage "in a transaction whose principal purpose and effect is to create a false appearance of revenues, intending to deceive investors in the corporation's stock." SEC *Amicus* Brief, *supra*, at 20. If a third party purchases products from a corporation pursuant to a legitimate contract that includes a right to return the products for a full refund, even with knowledge that the corporation will misreport the transaction as a final sale, the third party is an aider and abettor. But if this third party has a side agreement that no products will actually be shipped to it and it will not pay any monies, with the same awareness, then the third party can be a primary violator. *Id.* at 20-21. Thus, the focus, as the SEC properly makes clear, is on whether the act performed by the third party is itself inherently deceptive, the very conduct alleged in this case.

Moreover, Respondents' conduct was a direct causal connection with the injury to Petitioner and the class of purchasers of Charter's securities. As discussed above, Charter's stock price was driven by its revenue and operating cash flow. Respondents engaged in a fraudulent scheme and course of conduct deliberately intended to inflate those very results. There can be no doubt that the impact of Respondents' deceptive acts on Charter's stock price was not only foreseeable but actually intended. *See Parmalat*, 376 F. Supp. 2d at 509 (although defendants made no misrepresentations, "they knew that the very purpose of certain of their sham transactions was to allow Parmalat to make such misrepresentations," and that defendants' transactions "foreseeably caused losses in the securities market"); *see also Enron II*, 310 F. Supp. 2d at 829-30 (ruling that the sham transactions were "designed to deceive investors in and central to a scheme and course of business operating to present a falsely inflated image of Enron's financial strength"

and strongly disagreeing with the defendant's "contention that the alleged "'deception' did not occur until Enron allegedly misreported" the transactions).

Reliance on Respondents' fraudulent conduct by investors was connected to the injury alleged "even if a material misstatement by another person create[d] the [ultimate] nexus between the scheme and the securities market." *Lernout & Hauspie*, 236 F. Supp. 2d at 173. As the SEC stated in its *amicus* brief, *supra*: "The reliance element should be viewed as satisfied whenever a plaintiff relies on a material deception flowing from a deceptive act, even though the conduct of other participants in the scheme may have been a subsequent link in the causal chain leading to the plaintiffs securities transaction." *Id.* at 8. As the SEC explained: "Nothing in the rules of causation suggests that only the final act in a scheme to defraud meets the causation requirement." *Id.* at 21. It aptly recognized that "where the making of the false statements by one participant in the scheme is an objective of the scheme, the making of the statements should not be viewed as breaking the chain of causation." *Id.* at 22 (citing *Warshaw v. Xoma Corp.*, 74 F.3d 955, 959 (9th Cir. 1996); *Enron III*, 2006 U.S. Dist. LEXIS 43146, at *173.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT FILED APRIL 11, 2006

UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

No. 05-1974

In re: Charter Communications, Inc., Securities Litigation,

Stoneridge Investment Partners, LLS,

Plaintiff - Appellant,

v.

Scientific-Atlanta, Inc; Motorola, Inc.,

Defendants - Appellees.

Submitted: December 12, 2005
Filed: April 11, 2006

Before LOKEN, Chief Judge, WOLLMAN and RILEY, Circuit Judges.

LOKEN, Chief Judge.

This is a securities fraud class action by Stoneridge Investment Partners on behalf of those who purchased Charter Communications, Inc., stock between November 8,

1999 and August 16, 2002. Plaintiffs alleged that Charter—one of the nation's largest cable television providers—engaged in a "pervasive and continuous fraudulent scheme intended to artificially boost the Company's reported financial results" by deliberately delaying the disconnecting of customers no longer paying their bills, improperly capitalizing labor costs, and entering into sham transactions with two equipment vendors that improperly inflated Charter's reported operating revenues and cash flow. Named as defendants were Charter; ten Charter executives during all or part of the class period; Arthur Andersen, LLP, Charter's independent auditor during the class period; and the two equipment vendors, Scientific-Atlanta, Inc., and Motorola, Inc. (collectively, "the Vendors").

Relying on *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 114 S.Ct. 1439, 128 L.Ed.2d 119 (1994), the district court[1] granted the Vendors' motion to dismiss plaintiffs' claims under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and the SEC's implementing regulation, Rule 10b-5, 17 C.F.R. § 240.10b-5. The court then denied plaintiffs' motions to reconsider the dismissal and to grant leave to file an amended complaint. Stoneridge appeals. We have jurisdiction because the district court entered a separate final judgment under Rule 54(b) of the Federal Rules of Civil Procedure. We affirm.

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1. The HONORABLE CHARLES A. SHAW, United States District Judge for the Eastern District of Missouri.

Appendix A

I.

1. The Standard of Review. Plaintiffs' sixty-eight-page complaint is factually detailed, as it must be to satisfy the heightened pleading requirements of the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4(b). Our de novo review accepts the facts as alleged in the complaint and draws all reasonable inferences in favor of Stoneridge in deciding whether the complaint satisfied these pleading requirements. *See In re Navarre Corp. Sec. Litig.*, 299 F.3d 735, 740-48 (8th Cir.2002).

2. The Scheme Alleged. At the time in question, Charter delivered cable services through set-top boxes installed on customers' TV sets. Charter purchased the set-top boxes from third-parties, including the Vendors. In August 2000, although Charter had firm contracts with the Vendors to purchase set-top boxes at a set price sufficient for its present needs, Charter agreed to pay the Vendors an additional $20 per set-top box in exchange for the Vendors returning the additional payments to Charter in the form of advertising fees.

Plaintiffs alleged that these were sham or wash transactions with no economic substance, contrived to inflate Charter's operating cash flow by some $17,000,000 in the fourth quarter of 2000 in order to meet the revenue and operating cash flow expectations of Wall Street analysts. Charter accomplished the deception with fraudulent accounting by improperly capitalizing the increased equipment expenses while treating the returned advertising fees as immediate revenue. Plaintiffs alleged that the Vendors entered into these sham transactions knowing that Charter

intended to account for them improperly and that analysts would rely on the inflated revenues and operating cash flow in making stock recommendations. Plaintiffs did not allege that the Vendors played any role in preparing or disseminating the fraudulent financial statements and press releases through which Charter published its deception to analysts and investors.

3. The Governing Law. Section 10(b) makes it unlawful, directly or indirectly, "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." 15 U.S.C. § 78j(b). Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly . . . (a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

In *Central Bank*, the Supreme Court confirmed that § 10(b) prohibits only "manipulative or deceptive" devices or contrivances, and that private plaintiffs "may not bring a

[Rule] 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)." 511 U.S. at 173, 114 S.Ct. 1439. In earlier cases, the Court held that "deceptive" conduct involves either a misstatement or a failure to disclose by one who has a duty to disclose. *See Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 474-75 & n. 15, 97 S.Ct. 1292, 51 L.Ed.2d 480 (1977); *Affiliated Ute Citizens of the State of Utah v. United States*, 406 U.S. 128, 153-54, 92 S.Ct. 1456, 31 L.Ed.2d 741 (1972); *accord United States v. O'Hagan*, 521 U.S. 642, 653-655, 117 S.Ct. 2199, 138 L.Ed.2d 724 (1997). "Manipulative," as used in the securities context, is a "term of art" and refers to illegal trading practices such as "wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity." *Santa Fe*, 430 U.S. at 476-77, 97 S.Ct. 1292, citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 & n. 21, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976), and *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 43, 97 S.Ct. 926, 51 L.Ed.2d 124 (1977).

Based upon these earlier cases and the text and legislative history of the 1934 Act, the Court in *Central Bank* rejected the contrary position of the SEC and held that Rule 10b-5 does not reach those who only aid or abet a violation of § 10(b):

> As in earlier cases considering conduct prohibited by § 10(b), we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act. . . . The proscription does not include giving aid to a person who commits a manipulative or deceptive act.

511 U.S. at 177, 114 S.Ct. 1439. However, the concluding section of the *Central Bank* majority opinion added an important caveat:

> The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met.

Id. at 191, 114 S.Ct. 1439 (emphasis in original). This is one of many cases that have tested the boundaries of that caveat.

4. The District Court's Decision. In a thorough Memorandum and Order, the district court concluded that *Central Bank*, as uniformly applied by a number of our sister circuits, precludes plaintiffs' claims against the Vendors as nothing more than claims they aided and abetted Charter in committing § 10(b) violations:

> The Court concludes plaintiffs' claims against [the Vendors] are claims for aiding and abetting. Plaintiffs do not assert that [the Vendors] made any statement, omission or action at issue or that plaintiffs relied on any statement, omission or action made by either of them. Plaintiffs also do

> not allege that [the Vendors] were responsible for, or were involved with the preparation of Charter's allegedly false or misleading financial statements; Charter's allegedly improper internal accounting practices; or the allegedly false or misleading public statements made by Charter and its former executives. Plaintiffs also do not allege that any of the allegedly misleading statements listed in the amended complaint were made, seen, or reviewed by [the Vendors]. Instead, plaintiffs contend that [the Vendors] are liable to Charter's investors on the basis that they engaged in a business transaction that Charter purportedly improperly accounted for.
>
> Nor can [the Vendors] be held liable for any purported omissions as plaintiffs have not alleged that [the Vendors] had any duty to Charter's investors. . . . The Court can find no precedent for the conclusion that business partners, such as [the Vendors], made false and misleading statements by virtue of engaging in a business enterprise with a company such as Charter, the entity purported to have made the statements at issue.

Plaintiffs then filed motions for reconsideration and for leave to amend their complaint, citing additional cases and pleading additional facts. The district court denied both motions, concluding that the additional citations were unpersuasive and the proposed amendment would be futile because it merely reiterated the prior allegations with additional particularity.

Appendix A

II.

On appeal, Stoneridge argues that plaintiffs properly alleged a *primary* violation of the securities laws within the meaning of *Central Bank* because the Vendors violated Rule 10b-5(a) and (c) by participating in a "scheme or artifice to defraud" and by engaging in a "course of business which operates . . . as a fraud or deceit." The argument emphasizes that Rule 10b-5(a) and (c) are broadly worded and, unlike Rule 10b-5(b), do not require proof of a fraudulent misrepresentation or failure to disclose. The argument depends on the assertion that *Central Bank 's* analysis did not affect the scope of primary liability under subparts (a) and (c), relying primarily on a recent district court decision, *In re Parmalat Sec. Litig.*, 376 F.Supp.2d 472, 492-503 (S.D.N.Y.2005).

Like the district court, we reject Stoneridge's narrow interpretation of *Central Bank.* We conclude that *Central Bank* and the earlier cases on which it relied stand for three governing principles: (1) The Court's categorical declaration that a private plaintiff "may not bring a 10b-5 suit against a defendant for acts not prohibited by the text of § 10(b)," 511 U.S. at 173, 114 S.Ct. 1439, included claims under Rule 10b-5(a) and (c), as well as Rule 10b-5(b). (2) A device or contrivance is not "deceptive," within the meaning of § 10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose. *See Santa Fe*, 430 U.S. at 474- 75, 97 S.Ct. 1292.(3) The term "manipulative" in § 10(b) has the limited contextual meaning ascribed in *Santa Fe*, *id.* at 476-

77, 97 S.Ct. 1292.[2] Thus, any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5. *Accord Fidel v. Farley*, 392 F.3d 220, 235 (6th Cir.2004); *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1204-06 (11th Cir.2001); *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir.1998), *cert. denied*, 525 U.S. 1104, 119 S.Ct. 870, 142 L.Ed.2d 772 (1999); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1225-27 (10th Cir.1996); *In re Software Toolworks, Inc. Sec. Litig.*, 50 F.3d 615, 628 n. 3 (9th Cir.1994); *In re Dynegy, Inc. Sec. Litig.*, 339 F.Supp.2d 804, 914-16 (S.D.Tex.2004); *In re Homestore.com, Inc. Sec. Litig.*, 252 F.Supp.2d 1018, 1040-41 (C.D.Cal.2003).

In this case, the focus of plaintiffs' § 10(b) and Rule 10b-5 claims was deception—they alleged a "continuous course of conduct" in which Charter allegedly "made and/or failed to correct public representations which were or had become materially false and misleading regarding Charter's financial results and operations." Indeed, eighteen pages of the amended complaint alleged in fifty detailed paragraphs the fraudulent financial reports and press releases published by Charter during the class period. However, neither

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2. We agree with then-district judge Patrick Higginbotham that the Supreme Court in *Santa Fe* intended to limit § 10(b) claims of unlawful manipulation (as opposed to deception) to "transactions in the [securities] marketplace, the effects of which were to prevent the market price from accurately reflecting the market's unimpeded judgment of the stock's value." *Hundahl v. United Benefit Life Ins. Co.*, 465 F.Supp. 1349, 1360 (N.D.Tex.1979).

Motorola nor Scientific-Atlanta was alleged to have engaged in any such deceptive act. They did not issue any misstatement relied upon by the investing public, nor were they under a duty to Charter investors and analysts to disclose information useful in evaluating Charter's true financial condition. None of the alleged financial misrepresentations by Charter was made by or even with the approval of the Vendors. Accordingly, the district court properly dismissed the claims against the Vendors as nothing more than claims, barred by *Central Bank*, that the Vendors knowingly aided and abetted the Charter defendants in deceiving the investor plaintiffs.

Like the district court and the court in *In re Homestore.com*, 252 F.Supp.2d at 1041, we are aware of no case imposing § 10(b) or Rule 10b-5 liability on a business that entered into an arm's length non-securities transaction with an entity that then used the transaction to publish false and misleading statements to its investors and analysts. The point is significant. To impose liability for securities fraud on one party to an arm's length business transaction in goods or services other than securities because that party knew or should have known that the other party would use the transaction to mislead investors in its stock would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings. Decisions of this magnitude should be made by Congress.

Appendix A

III.

Finally, Stoneridge argues that the district court abused its discretion in denying plaintiffs' post-dismissal motions to reconsider the dismissal order and to grant plaintiffs leave to amend the complaint. A district court has broad discretion to reconsider an order granting dismissal or summary judgment, but "[a] motion to alter or amend judgment cannot be used to raise arguments which could have been raised prior to the issuance of judgment." *Hagerman v. Yukon Energy Corp.*, 839 F.2d 407, 414 (8th Cir.), *cert. denied*, 488 U.S. 820, 109 S.Ct. 63, 102 L.Ed.2d 40 (1988). Here, plaintiffs argued that the district court overlooked or misapplied prior decisions from district courts in other circuits. The district court briefly reviewed those cases and concluded it "is not inclined to reach a different result." Denial of the motion to reconsider on this ground was not an abuse of discretion. Indeed, we agree with the court's analysis of those non-controlling cases.

The district court denied the post-dismissal motion to amend because the proposed pleading would be futile—the additional allegations as to the Vendors' role and knowledge set forth in the proposed amended complaint did not cure the flaws in plaintiffs' § 10(b) theory. Denial of a motion to amend on this ground, particularly a motion filed after the district court's final ruling, is not an abuse of discretion. *See, e.g., Grandson v. Univ. of Minn.*, 272 F.3d 568, 575 (8th Cir.2001), *cert. denied*, 535 U.S. 1054, 122 S.Ct. 1910, 152 L.Ed.2d 820 (2002).

The Final Judgment of the district court dated February 15, 2005, is affirmed.

APPENDIX B — FINAL JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF MISSOURI, EASTERN DIVISION DATED FEBRUARY 15, 2005

THE UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MISSOURI
EASTERN DIVISION

MDL Docket No. 1506 (CAS)
All Cases

Consolidated Case
No. 4:02-CV-1186 CAS

IN RE CHARTER COMMUNICATIONS, INC. SECURITIES LITIGATION

STONERIDGE INVESTMENT PARTNERS LLC, Individually and On Behalf of All Others Similarly Situated,

Plaintiff,

v.

CHARTER COMMUNICATIONS, INC., PAUL ALLEN, JERALD L. KENT, CARL E. VOGEL, KENT KALKWARF, DAVID G. BARFORD, PAUL E. MARTIN, DAVID L. McCALL, BILL SHREFFLER, CHRIS FENGER, JAMES H. SMITH, III and ARTHUR ANDERSEN, LLP,

Defendants.

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FINAL JUDGMENT PURSUANT TO FED. R. CIV. P. 54(b) AS TO SCIENTIFIC-ATLANTA, INC. AND MOTOROLA, INC.

WHEREAS, on October 12, 2004, this Court entered an Order, in relevant part, granting defendants Scientific-Atlanta, Inc.'s ("Scientific-Atlanta") and Motorola, Inc.'s ("Motorola") motions to dismiss Count V of the Amended and Consolidated Class Action Complaint; and

WHEREAS, on December 20, 2004, this Court entered an Order, in relevant part, (1) denying plaintiffs' motion to amend to add additional allegations to the complaint detailing the role and knowledge of Scientific-Atlanta and Motorola; and (2) denying plaintiffs' motion for reconsideration of the Court's Order dated October 12, 2004 granting Scientific-Atlanta's and Motorola's motions to dismiss; and

WHEREAS, plaintiffs have filed a motion pursuant to Fed. R. Civ. P. 54(b) seeking to sever the claims against defendants Scientific-Atlanta, Inc. and Motorola, Inc. and requesting that the Court expressly direct the entry of a final judgment thereon; and

WHEREAS, plaintiffs have reached a settlement with all remaining parties to this action; and

WHEREAS, there are no other claims to be adjudicated;

IT IS HEREBY ORDERED ADJUDGED AND DECREED THAT:

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1. There is no just reason for delay in entering final judgment on plaintiffs' claims against defendants Scientific-Atlanta and Motorola.

2. The Court hereby expressly directs that this final judgment pursuant to Fed. R. Civ. P. 54(b) be entered in this action.

3. Plaintiffs' Amended Consolidated Class Action Complaint is dismissed with prejudice against defendants Scientific-Atlanta and Motorola.

4. Plaintiffs' motion for reconsideration of the Court's Order dismissing plaintiffs' Amended Consolidated Class Action Complaint against defendants Scientific-Atlanta and Motorola is denied with prejudice.

SO ORDERED.

DATED: 2/15/05

s/ Charles A. Shaw
CHARLES A. SHAW
UNITED STATES DISTRICT JUDGE

APPENDIX C — MEMORANDUM AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF MISSOURI, EASTERN DIVISION DATED DECEMBER 20, 2004

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MISSOURI
EASTERN DIVISION

MDL DOCKET 1506
ALL CASES

Consolidated Case
No. 4:02-CV-1186 CAS

IN RE CHARTER COMMUNICATIONS, INC.,
SECURITIES LITIGATION

STONERIDGE INVESTMENT PARTNERS LLC,
Individually and On Behalf of All Others
Similarly Situated,

Plaintiffs,

v.

CHARTER COMMUNICATIONS, INC., et al.,

Defendants.

MEMORANDUM AND ORDER

This matter is before the Court on Lead Plaintiff's motions to amend the Amended Consolidated Class Action Complaint ("Complaint") and for reconsideration of the

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Court's October 12, 2004 order granting Scientific-Atlanta and Motorola's ("Vendor Defendants") motions to dismiss. The Vendor Defendants have opposed the motion and the motion is fully briefed.

I. BACKGROUND

The Court hereby incorporates into this memorandum and order the factual allegations and applicable law set forth in the Court's October 12, 2004 memorandum and order. Lead plaintiff now moves to (1) amend the Complaint to extend the Class Period by one month to conform with the evidence developed to date, as well as the terms of the Partial Settlement; (2) amend the Complaint to add additional allegations detailing the role and knowledge of Scientific Atlanta, Inc. ("Scientific-Atlanta") and Motorola, Inc. ("Motorola") in the fraudulent scheme; and (3) request reconsideration of the Court's October 12, 2004 order to the extent it granted the motions to dismiss filed by Scientific-Atlanta and Motorola.

An agreement in principle has been reached with Charter, its officers and controlling shareholders, to settle claims against these defendants for payment of $144 million in cash and securities. The terms of that agreement are still being negotiated. In the meantime, Lead Plaintiff states it has conducted a review of nearly one million pages of documents produced by Charter and has interviewed key personnel. The discovery focused in part on claims asserted against the non-settling defendants, Arthur Andersen LLP and the Vendor Defendants.

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Lead Plaintiff's claims against the Vendor Defendants arise out of a series of fraudulent swap transactions that occurred during 2000 that were intended to artificially boost Charter's operating cash flow ("OCF") sufficiently to overcome an anticipated $17 million shortfall. The transactions involved Charter's agreement to pay $20 more for each digital converter set top box purchased and the Vendor Defendants' agreement to return these monies to Charter in the form of advertising.

Lead Plaintiff now states that facts elicited during discovery lend support to its claims against the Vendor Defendants, warranting amendment of the Complaint and reconsideration of the Court's dismissal of the claims asserted against them. In particular, plaintiffs state their discovery reveals that the Vendor Defendants had "non-public information" regarding the fraudulent nature of Charter's efforts to generate the appearance of additional revenues and cash flow during the fourth quarter of 2000.

To that end, Lead Plaintiff asserts the following in its Proposed Second Amended Consolidated Class Action Complaint. The Vendor Defendants manufactured and sold equipment that decoded digital cable signals for viewing on television sets. This equipment was typically contained in a box that sat on top of a television set ("set top boxes").

By August 2000, Charter had pre-existing agreements with the Vendor Defendants to purchase significant numbers of set top boxes at agreed upon prices. (Proposed Second Amended Consolidated Class Action Complaint at ¶ 94.) The Scientific-Atlanta agreement, which had been modified in

July 2000, one month earlier, called for the purchase of over 450,000 set top boxes by the end of 2000, and an additional 1 million boxes in 2001-2002. (*Id.* at ¶¶ 95-96.) The price for the boxes was predetermined in the agreement. The Motorola agreement, dated December 7, 1999, called for Charter to purchase 1 million set top boxes over the two-year period 2000-2001, also at prices determined in the agreement. (*Id.* at 94.)

In August 2000, Charter was facing a year-end OCF shortfall of $15 to $20 million. (*Id.* at 91.) In order to cover this shortfall, defendants David Barford and Kent Kalkwarf, Charter's CEO and COO, respectively, instructed John Pietri, Charter's Senior Vice-President of Engineering, to approach Scientific-Atlanta and Motorola and urge them to purchase advertising from Charter. Pietri did so. Both Vendor Defendants initially declined. (*Id.* at ¶ 92.)

On further instruction from his superiors, Pietri then approached the Vendor Defendants with proposals to engage in sham transactions, the sole purpose of which was to generate the appearance of OCF growth for Charter. (*Id.* at ¶ 97.) Charter offered to pay the Vendor Defendants $20 more per set top box for the same amount of boxes that it had previously agreed to purchase. The transactions were to be completed before the end of 2000. In return, the Vendor Defendants agreed to use the additional $20 per box to pay Charter for advertising spots to be aired before the end of the year. (*Id.* at ¶¶ 97-99.) The Vendor Defendants agreed to the sham transactions, despite their knowledge that the advertising rates they were being charged exceeded the market rates by four to five times. (*Id.* at ¶ 106.) As a result,

Charter's OCF was inflated by $17 million for the fourth quarter of 2000. (*Id.* at ¶ 108.)

The direct participants in the scheme included high level personnel of the Vendor Defendants, including Jeffrey Pierce, Director of National Accounts for a division of Motorola; Steve Kaufman, National Business Manager for Scientific-Atlanta; and Tom Nilson, Managing Director for North American Sales for Scientific-Atlanta.

Once the basic terms of the sham transactions were agreed to, the participants set out to create fraudulent documentation. On August 28, 2000, Charter's Pietri e-mailed Nilson, instructing Scientific-Atlanta to notify Charter that the Vendor Defendant was raising the prices of its set top boxes. (*Id.* at ¶ 100.) Charter advised Scientific-Atlanta to fabricate this documentation, because no such increase was planned by Scientific-Atlanta. (*Id.*) Pietri also told Nilson precisely what to state in the letter, including the number of boxes affected, and a penalty provision to ensure that there was a pretext for Charter paying Scientific-Atlanta the precise amount needed to fund the advertising. (*Id.*) In the "pricing increase notification letter," Pietri specifically instructed Nilson to set forth: (1) the reason for the price increase and the date, September 1, 2000, of the increase; (2) a description of the quantities of set tops this letter would cover, i.e., the anticipated number of set tops, 351, 180, that Scientific-Atlanta expected to ship and Charter expected to take delivery of between September 1, 2000 and December 21, 2000; and (3) a penalty provision in the event Charter did not accept the anticipated number of set tops in the specified time frame. Pietri also stated he would be sending the advertising contract

for review prior to the final particulars being worked out. (*Id.* at ¶ 100 .)

Both parties to this agreement knew that the number of boxes covered was the same amount that Charter had locked into a purchase agreement executed a few months earlier. (*Id.* at ¶ 102.) Not only did Scientific-Atlanta know that there was no price increase, but it had already agreed to give Charter a "most favored customer" clause, meaning that Scientific-Atlanta could not impose a price increase without doing so for each of its customers. (*Id.*)

Following this e-mail, Pietri e-mailed Wes Hart, Charter's Vice President of Advertising Sales, copying defendant Barford and other marketing personnel, and requested an advertising contract totaling $6,823,080 for Scientific-Atlanta, the final contract price being $6,730,000). (*Id.* at ¶ 101.)

Consistent with Pietri's instructions, on August 31, 2000, Steve Kaufman of Scientific-Atlanta notified Charter that purportedly due to increased manufacturing costs, Scientific-Atlanta was increasing the price for all set top boxes scheduled to be purchased by Charter for the balance of the year. Scientific-Atlanta understood that this was not true. (*Id.* at ¶ 102.)

Prior to August 2000, Charter had no agreements for spot telecasting with any cable equipment vendors. (*Id.* at ¶ 91.) However, in September 2000, Scientific-Atlanta and Charter, in furtherance of the scheme, entered into marketing support agreements entitled "Spot Telecasting and Digital Marketing

Support Fee Agreements." These were executed on September 15, 2000 by Pietri, and on September 21, 2000 by Scientific-Atlanta. (*Id.* at ¶ 107 .) These agreements were not the product of arms-length negotiations, but rather the product of simple math to determine how best to funnel the millions that Charter had agreed to pay for the sham price increase back to Charter. In fact, the rates that Scientific-Atlanta agreed to pay were four to five times more than the price that other parties had paid Charter for such time slots in 2000. (*Id.* at ¶ 106.) In the end, Charter agreed to pay $6,730,000 more for the boxes it had previously agreed to buy, and Scientific-Atlanta agreed to pay $6,730,000 for advertising well in excess of its market value, which Scientific-Atlanta did not need anyway. (*Id.* at ¶ 101-2.)

Lead Plaintiff further asserts the pattern with Motorola was the same, although the mechanism was more unusual and the impact larger. On August 31, 2000, the same day as the purported increase in price for the Scientific-Atlanta boxes, Jeffrey Pierce of Motorola and Pietri signed a contract whereby Charter agreed to purchase 540,000 set top boxes in the four month period from September 1, 2000 to December 31, 2000. (*Id.* at ¶ 103.) Only eight months earlier Charter had agreed to purchase 1,000,000 set top boxes from Motorola for the entire 24 month period from 2000 to 2001. The 540,000 units represented the total amount of set top boxes that would likely be purchased during the twelve month period of 2001. (*Id.* at ¶ 103.)

Equally startling is the fact that Charter agreed to pay Motorola $20 in liquidated damages for each unit that Charter failed to purchase during the agreed upon four month time

frame. (*Id.*) Thus, it was clearly understood by both parties to this "contract" that Charter had no intention of ever purchasing the additional units. In fact, the cost of such purchases would have been $140 million dollars, which as Motorola could have ascertained from Charter's publicly disclosed financials, Charter did not have on hand. (*Id.* at ¶ 104.) There was clearly no benefit to Charter suddenly accelerating its purchases of these set top boxes. The only benefit to Charter was not to purchase the set top boxes and to funnel the $10,800,000 penalty to Motorola so that Motorola could return the monies to Charter in the form of advertising payments. (*Id.* at ¶ 105.)

On September 29, 2000, Motorola also entered a spot telecast contract with Charter, agreeing to pay $10,800,000 for advertising it did not need, and at rates that were inflated. (*Id.* at ¶ 107.)

As a result of this scheme, Charter overstated its reported OCF by more than $17.5 million for the fourth quarter of 2000. (*Id.* at ¶ 109.) This enabled Charter to meet analyst expectations and to further buoy Charter stock at an artificially inflated price. Charter ultimately restated its results for the year 2000.

Lead Plaintiff seeks to amend the complaint to add the foregoing allegations detailing the Vendor Defendants' participation in, and knowledge of, the fraudulent scheme to inflate Charter's revenues and OCF. Lead Plaintiff argues that the new facts are highly probative of the Vendor Defendants' direct participation in and knowledge of the scheme to defraud investors. They assert there is no other

explanation for the opportunistic price increase, the round tripping of revenues, Charter's willingness to pay a penalty equivalent to the price increase if it did not take shipment of the boxes, and the Vendor Defendants' willingness to pay inflated prices for advertising. Lead Plaintiff states these details came to light only through recent discovery efforts after the motions to dismiss had been briefed and therefore reconsideration of this Court's October 12, 2004 order dismissing the claims against the Vendor Defendants is warranted.

The Vendor Defendants oppose the motion, and each filed a separate response. Motorola argues the new information does nothing to impact this Court's conclusion with respect to *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191, 114 S.Ct. 1439, 128 L.Ed.2d 119 (1994). It asserts the "new" facts are merely minor reworkings of the same allegations in the prior complaint. Motorola contends the new facts allegedly relate to Motorola's scienter, even though this Court did not reach that question. Thus, even if the new facts plaintiffs seek to allege were true, this Court's prior decision would remain the same. Motorola further argues Lead Plaintiffs cannot circumvent *Central Bank* by simply asserting the Vendor Defendants were part of a scheme. Motorola also contends the additional decisions cited by Lead Plaintiff do not support plaintiff's position.

In its response, Scientific-Atlanta asserts Lead Plaintiff has not shown any manifest error of law or any other exceptional circumstances that justify relief. It further argues that pleading additional particularity cannot transform it from an aider and abettor into a primary violator of the federal securities laws.

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II. DISCUSSION

The Federal Rules of Civil Procedure do not mention motions for reconsideration. A "motion for reconsideration" which is directed to a non-final order may only be construed as a motion under Rule 60(b). *Broadway v. Norris, 193 F.3d 987* (8th Cir.1999). "[A]s a rule courts should be loathe to [revisit prior decisions] in the absence of extraordinary circumstances such as where the initial decision was 'clearly erroneous and would work a manifest injustice.'" *Christianson v. Colt Indus. Operating Corp.*, 486 U.S. 800, 817, 108 S.Ct. 2166, 100 L.Ed.2d 811 (1988) (quoting *Arizona v. California*, 460 U.S. 605, 618 n. 8, 103 S.Ct. 1382, 75 L.Ed.2d 318 (1983)) (discussing law of the case doctrine). Reconsideration is appropriate to correct manifest errors of law or fact, or to present newly-discovered evidence. *Harsco Corp. v. Zlotnicki*, 779 F.2d 906, 909 (3rd Cir.1985), *cert. denied*, 476 U.S. 1171, 106 S.Ct. 2895, 90 L.Ed.2d 982 (1986) (citation omitted) (concerning motion for reconsideration of summary judgment order). A further basis for a motion to reconsider would be a controlling or significant change in the law or facts since the submission of the issues to the Court. *See e.g. Above the Belt, Inc. v. Mel Bohannon Roofing, Inc.*, 99 F.R.D. 99, 101 (E.D.Va.1983) (motion to reconsider summary judgment order.)

The Court finds that plaintiff's motion pleads additional particularity and merely reiterates in part the allegations of the Complaint, and so fails to meet the cited criteria. Lead Plaintiff cites two cases it believes the Court overlooked in its ruling dismissing the complaint as to the Vendor Defendants, *In re Enron Corp. Sec. Deriv. & ERISA Litig.*,

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310 F.Supp.2d 819 (S.D.Tex.2004) ("Enron II")[1] and *In re Global Crossing, Ltd. Sec. Litig.*, 322 F.Supp.2d 319 (S.D.N.Y.2004).

In *Enron II*, brokerage firm Merrill Lynch moved to dismiss, maintaining Lead Plaintiffs' claims were barred by *Central Bank*. The district court denied Merrill Lynch's motion to dismiss, holding the allegations in the complaint were sufficient to show Merrill Lynch liable as a primary violator under the scheme prong of § 10(b) and Rule 10b-5. The district court acknowledged its rejection of the "narrow construction of the statute and of primary violations employed by *Homestore.com*." *See* 310 F.Supp.2d at 828. The court held Lead Plaintiff alleged with specificity that Merrill Lynch "directly or indirectly" employed a scheme to defraud and engaged in acts, practices, and a course of business over the Class Period, as well as issued numerous analysts' reports and recommendations containing false and misleading statements about Enron's financial condition, as part of the purported Ponzi scheme that was intended to and did operate as a fraud or deceit upon investors in connection with the purchase of Enron securities. Lead Plaintiff made new and specific allegations regarding the Merrill Lynch's deceptive conduct in a Nigerian barge deal which involved

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1. The Court notes that in its memorandum in support of this motion, Lead Plaintiff misquotes a lengthy portion of the *Enron II* decision by failing to indicate where language was omitted. As a result, the passage "quoted" by Lead Plaintiff is not accurate and misleading. In future submissions to the Court, Lead Plaintiff should indicate—through the use of ellipses—where omissions by the writer have been made. *See generally*, *A Uniform System of Citation*, "Omissions," Rule 5.3.

purchasing Nigerian barges from Enron to create sham earnings of over $12 million in return for a secret, oral side agreement with Andrew Fastow that Enron would repurchase them within six months so there would be no risk, but only a lucrative profit for Merrill Lynch. *Id.* at 829. The district court held that such allegations, among others, suggested a strong inference that Merrill Lynch knew the Nigerian barge deal was a phony transaction created to manipulate Enron's income statements in return for Merrill Lynch's lucrative 15% return. *Id.* The district court further noted the complaint alleged an ongoing scheme that Merrill Lynch participated in for years and that resulted in "enormous financial returns for Merrill Lynch officers who personally invested in it as well as lucrative earnings for the company." *Id.* at 830.

In *In re Global Crossing, Ltd. Sec. Litig.*, 322 F.Supp.2d 319, 336 (S.D.N.Y.2004), the district court held outside auditor Arthur Andersen was potentially liable under the scheme prong of Rule 10(b)(5), noting plaintiffs' claims against Arthur Andersen went "far beyond mere aiding and abetting." The court first noted plaintiffs clearly alleged that Andersen "committed a manipulative or deceptive act in furtherance of the alleged scheme to defraud." *Id.* The court then noted the complaint asserted that Andersen "masterminded misleading accounting and sham swap transactions used to circumvent GAAP and inflate the Companies' revenues, that it actively participated in structuring each swap, that it was intimately involved" in all of Global Crossing and Asia Global Crossing's accounting functions, and that it "directly participated" in the creation of misleading "pro forma" numbers that concealed these practices from investors. The court found "Andersen's

allegedly central role in these schemes, as their chief architect and executor, leaves no doubt as to its potential liability as a primary violator under section 10(b)." *Id.*

After reviewing the additional authorities cited by Lead Plaintiffs, the Court is not inclined to reach a different result. Unlike in *Global Crossing* where the court found Andersen the "chief architect and executor" of the alleged schemes, here there are no allegations that the Vendor Defendants had similar involvement with respect to Charter's internal accounting or preparation of its financial statements. In *Enron II*, lead Plaintiff alleged Merrill Lynch issued numerous analysts' reports and recommendations containing false and misleading statements about Enron's financial condition. Lead Plaintiff made no such allegations here. Thus, Lead Plaintiff's motion for reconsideration should be denied.

Likewise, the Court will deny the motion to amend the complaint to add additional allegations detailing the role and knowledge of Scientific Atlanta and Motorola in the fraudulent scheme. Although a pretrial motion for leave to amend is to be liberally granted, different considerations apply to motions filed after dismissal. *Dorn v. State Bank of Stella*, 767 F.2d 442, 443 (8th Cir.1985) (citations omitted). After a complaint is dismissed, the right to amend under Fed.R.Civ.P. 15(a) terminates. *Id., citing Czeremcha v. International Association of Machinists and Aerospace Workers*, 724 F.2d 1552, 1556 (11th Cir.1984). The decision whether to allow amendment of a complaint is. left to the Court's sound discretion. *Anderson v. Alpha Portland Industries, Inc.*, 836 F.2d 1512, 1521 (8th Cir.1988), *cert. denied*, 489 U.S. 1051, 109 S.Ct. 1310, 103 L.Ed.2d 579

(1989). It is appropriate to deny leave to amend where the filing of the amended complaint would be futile. *Humphreys*, 990 F.2d at 1082; *Harbor Insurance Co. v. Essman*, 918 F.2d 734, 739 (8th Cir.1990), *citing Niagra of Wisconsin Paper Corp. v. Paper Industries Union-Management Pension Fund*, 800 F.2d 742, 749 (8th Cir.1986). The Court concludes that in light of the above, amending the complaint would be futile.

Finally, the Court will grant Lead Plaintiff's motion for leave to amend the Complaint to extend the Class Period by one month to conform with the evidence developed to date, as well as the terms of the Partial Settlement.

Accordingly,

IT IS HEREBY ORDERED that Stoneridge Partners, LLC's motion to amend or correct is **GRANTED in part and DENIED in part**. (Doc. 264.) The motion is denied to the extent it seeks to add additional allegations to the complaint detailing the role and knowledge of Scientific Atlanta and Motorola in the fraudulent scheme. The motion is granted to the extent it extends the Class Period by one month to conform with the evidence developed to date and the terms of the Partial Settlement.

IT IS FURTHER ORDERED that Stoneridge Partners, LLC's motion for reconsideration is **DENIED**. (Doc. 264.)

IT IS FURTHER ORDERED that Scientific-Atlanta's motion for leave to file a supplemental memorandum in support of its motion to amend the complaint and to reconsider dismissal of claims is **DENIED**. (Doc. 272.)

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IT IS FURTHER ORDERED Lead Plaintiff shall file an amended complaint extending the Class Period by one month to conform with the evidence developed to date and the terms of the Partial Settlement by January 3, 2005.

s/ Charles A. Shaw
CHARLES A. SHAW
UNITED STATES DISTRICT JUDGE

Dated this 20th day of December, 2004.

APPENDIX D — MEMORANDUM AND ORDER OF THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF MISSOURI, EASTERN DIVISION DATED OCTOBER 12, 2004

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MISSOURI
EASTERN DIVISION

MDL DOCKET 1506
ALL CASES

Consolidated Case
No. 4:02-CV-1186 CAS

IN RE CHARTER COMMUNICATIONS, INC.,
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STONERIDGE INVESTMENT PARTNERS LLC,
Individually and On Behalf of All Others
Similarly Situated,

Plaintiffs,

v.

CHARTER COMMUNICATIONS, INC., et al.,

Defendants.

MEMORANDUM AND ORDER

This matter is before the Court on several motions to dismiss for failure to state a claim. Plaintiffs oppose the motions and the matter is now fully briefed. The Court will

grant the motion as to Scientific-Atlanta and Motorola, and deny the motion as to Arthur Andersen for the reasons set forth below. The Court will also enter the protective order submitted by the parties.

I. BACKGROUND

Charter Communications, Inc. ("Charter") is a cable operator that provides video, data, interactive and private business network services to customers in forty states through the company's broadband network of coaxial and fiber optic cable. The company offers traditional analog cable as well as digital television services, along with an array of advanced products and services such as high-speed Internet access, interactive video programming and video-on-demand.

This is a putative securities class action filed on behalf of investors who purchased Charter securities during the period from November 8, 1999 through July 17, 2002 (the "Class Period"). In addition to Charter, plaintiffs named as defendants current and former senior executives, Arthur Andersen LLP, an accounting firm headquartered in Chicago, Illinois, which served as Charter's independent auditor during the Class Period; and Scientific-Atlanta, Inc. ("Scientific-Atlanta") and Motorola, Inc. ("Motorola"), two of Charter's vendors that manufacture electronic equipment, including digital set-top boxes used in the cable industry.

Upon motion of several of the parties, the Court temporarily stayed the proceedings so that the parties could pursue mediation. The parties who participated in the mediation reached a tentative agreement that is subject to

the Court's approval. Prior to the stay, Scientific-Atlanta, Motorola,[1] and Arthur Andersen—who are not parties to the tentative settlement—moved to dismiss the amended complaint for failure to state a claim upon which relief can be granted under Federal Rules 12(b)(6) and 9(b), and the Private Securities Litigation Reform Act of 1995 ("PSLRA" or "Reform Act"), 15 U.S.C. § 78u-4(b). These motions are now before the Court.

In their Amended Consolidated Class Action Complaint ("Amended Complaint"), plaintiffs allege, *inter alia*, defendants (1) engaged in a fraudulent scheme to artificially boost the company's customer base and reported financial results; (2) inflated Charter's internal customer growth rate by deliberately delaying "disconnects" for over 100,000 customers who were no longer paying their bills or who had advised the company they wished to terminate their service; and (3) materially inflated Charter's operating cash flow by improperly capitalizing labor-related and other costs that should have been expensed.

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1. The plaintiffs' allegations as to Motorola and Scientific-Atlanta are pled collectively as to both defendants. While Scientific-Atlanta and Motorola filed separate motions to dismiss, Motorola adopts Scientific-Atlanta's arguments to the extent they are applicable to Motorola.

Appendix D

II. DISCUSSION

A. Pleading Standard under PSLRA

A motion to dismiss will not be granted unless it "appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Conley v. Gibson*, 355 U.S. 41, 45, 78 S.Ct. 99, 2 L.Ed.2d 80 (1957). In considering a motion to dismiss for failure to state a claim upon which relief can be granted under Federal Rules of Civil Procedure 12(b)(6) and 9(b), this Court must view the factual allegations in the light most favorable to the plaintiff. *Parnes v. Gateway 2000, Inc.*, 122 F.3d 539, 546 (8th Cir.1997). The facts alleged in the complaint are assumed to be true. *In re Navarre Corp. Sec. Litig.*, 299 F.3d 735, 738 (8th Cir.2002).

"Complaints brought under Rule 10b-5 and section 10(b) are governed by special pleading standards adopted by Congress in the [Reform Act]. These pleading standards are unique to securities and were adopted in an attempt to curb abuses of securities fraud litigation." *Navarre Corp.*, 299 F.3d at 741. Congress enacted two heightened pleading requirements in the Reform Act. First, the Reform Act requires the plaintiff's complaint to specify each misleading statement or omission and specify why the statement or omission was misleading. 15 U.S.C. § 78u-4(b)(1) (Supp. IV 1998). If the allegation "is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." *Id.* Similarly, Rule 9(b) of the Federal Rules of Civil Procedure has long required that "in all averments of fraud or mistake, the circumstances constituting

fraud or mistake shall be stated with particularity." The text of the Reform Act was designed "to embody in the Act itself at least the standards of *Rule 9(b)*." *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 193 (1st Cir.1999).

Second, Congress stated in the Reform Act that a plaintiff's complaint must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u4(b)(2); *Florida State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 654 (8th Cir.2001). The Reform Act requires the court to dismiss the complaint if these requirements are not met. 15 U.S.C. § 78u-4(b)(3). In the securities fraud context, this Court must "disregard 'catch-all' or 'blanket' assertions that do not live up to the particularity requirements of the [Reform Act]." *Green Tree*, 270 F.3d at 660. "[U]nder the Reform Act, a securities fraud case cannot survive unless its allegations collectively add up to a strong inference of the required state of mind." *Green Tree*, 270 F.3d at 660. "Congress has effectively mandated a special standard for measuring whether allegations of scienter survive a motion to dismiss. While under Rule 12(b)(6) all inferences must be drawn in plaintiffs' favor, inferences of scienter do not survive if they are merely reasonable. . . . Rather, inferences of scienter survive a motion to dismiss only if they are both reasonable and 'strong' inferences." *Id.* (quoting *Greebel*, 194 F.3d at 195-96) (alterations in original).

Plaintiffs brought causes of action under § 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Securities and Exchange Commission ("SEC") Rule 10b-5(b)

promulgated thereunder. Section 10(b) of the Exchange Act states in relevant part:

> It shall be unlawful for any person, directly or indirectly . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may proscribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b). Rule 10b-5 implements this statute, stating:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

> (c) To engage in any act, practice or course of business which operated or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

B. Scientific-Atlanta and Motorola

According to the Amended Complaint, Scientific-Atlanta is headquartered in Lawrenceville, Georgia and is a leading manufacturer of products for the cable television industry. It designs, develops, and manufactures innovative products which it sells to several cable system operators, also known as "Multiple System Operators" ("MSOs"), one of which is Charter. Motorola is based in Schaumberg, Illinois, and is also one of the country's leading manufacturers of electronic equipment, including products for the cable television industry.

The MSOs use products from Scientific-Atlanta and Motorola, who are primary competitors, as well as other vendors, to distribute video and other services to their consumer cable subscribers. One of the products that Scientific-Atlanta and Motorola manufacture and distribute to the MSOs is a "digital set-top," a unit that is typically placed on top of a television set to enable the customer to access digital cable television and other digital services. Charter purchases this equipment and supplies it to its customers so they can view Charter's cable television programs. In 2000, the digital set-top was a relatively new product, and cable operators such as Charter marketed its new features to prospective and existing cable customers.

Appendix D

Plaintiffs assert that Charter entered into sham arrangements with Motorola and Scientific-Atlanta intended to boost Charter's revenues and operating cash flow. In order to provide digital cable television service, it was necessary for Charter to purchase digital cable converter boxes for installation in customers' homes. The purchases of these digital cable converter boxes became a large capital expense for Charter and made Charter an important customer of Scientific-Atlanta and Motorola, the two largest manufacturers of such converter boxes and other equipment used by cable companies. (Am. Compl. at ¶ 75.)

In August 2000, defendants Kent D. Kalkwarf, former Executive Vice President and Chief Financial Officer, and David G. Barford, former Executive Vice President and Chief Operating Officer, realized that Charter was facing a year-end shortfall in operating cash flow relative to amounts projected by Charter and those analysts who covered the company. In order to cover that shortfall, Charter entered into sham agreements for "advertising" from Scientific-Atlanta and Motorola to inflate Charter's operating cash flow for the fourth quarter of 2000. (*Id.* at ¶ 76.) As part of the sham transactions, Charter agreed to pay Scientific-Atlanta and Motorola an additional $20 for each digital converter so long as suppliers repaid that same amount to Charter in the form of "advertising." (Emphasis in Amended Complaint). Thus, the price increases paid by Charter and "advertising" payments made by the vendors constituted "wash" transactions with no economic substance. (*Id.* at ¶ 77.)

Although these sham agreements could have no legitimate effect on Charter's operating cash flow, defendants

exploited such transactions by fraudulently accounting for them in such a way as to significantly and artificially inflate Charter's operating cash flow during the Class Period, by treating the "payments" from Scientific-Atlanta and Motorola as "revenues" when in fact they were simply the return of Charter's own monies. (*Id.* at ¶ 78.)

On the other hand, Charter avoided any adverse effect or decrease on its operating cash flow by capitalizing the payments made to Scientific-Atlanta and Motorola, under the pretext that they were related to the purchase of equipment. Thus, although the advertising payments had no economic effect whatsoever on Charter, through their misleading and fraudulent accounting for the transactions, the defendants used them to artificially increase Charter's publicly disclosed operating cash flow by at least 17 million dollars during the fourth quarter of 2000. But for this scheme, Charter's reported revenues and operating cash flow would have fallen short of analyst expectations. (*Id.* at ¶ 79.)

Plaintiffs assert Scientific-Atlanta and Motorola agreed to such sham transactions knowing or recklessly disregarding that Charter intended to inflate its reported results by recording the monies it received as revenues, while recording monies it paid to them as capital expenses. Plaintiffs assert Scientific-Atlanta and Motorola also knew that analysts would be relying upon such reported amounts in making their recommendations on Charter's stocks. (*Id.* at ¶ 196.) They further allege that by virtue of such conduct, Scientific-Atlanta and Motorola made materially misleading statements to Charter investors knowing or recklessly disregarding that such statements were false or misleading, in violation of

§ 10(b) and Rule 10b-5(b). (*Id.* at ¶ 197.) Alternatively, plaintiffs claim that these sham transactions constituted a "device, scheme, or artifice to defraud" and "an act, practice or course of business which operate[d] . . . as a fraud or deceit" upon Charter investors in violation of Rule 10b-5(a) and (c). (*Id.* at ¶ 198.)

In support of their motions, Scientific Atlanta and Motorola argue that plaintiffs' claims amount to aiding and abetting liability under § 10(b) and Rule 10b-5, and are therefore barred by the Supreme Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191, 114 S.Ct. 1439, 128 L.Ed.2d 119 (1994). They further maintain plaintiffs have failed to plead the required elements to state a claim for primary liability under any subpart of § 10(b) or Rule 10b-5. They also contend the Amended Complaint fails to satisfy the pleading requirements of the PSLRA because it fails to specify each statement attributed to them that is alleged to be misleading and the reason or reasons why the statement is misleading. Finally, they argue plaintiffs have failed to plead the strong inference of scienter to "deceive, manipulate or defraud" Charter's investors as required under the Reform Act.

The Court concludes that plaintiff's claims against Scientific-Atlanta and Motorola amount to claims for aiding and abetting liability under § 10(b) and Rule 10b-5. Under any subsection of those provisions, plaintiffs' claims against these defendants are barred by the Supreme Court's decision in *Central Bank. Central Bank* held that "there is no private aiding and abetting liability under § 10(b)" of the Exchange Act. *Id.* at 191. The Supreme Court examined the text of the

Exchange Act and concluded that Congress did not intend to impose secondary liability under section 10(b). *Id.* at 184. The Court also observed that allowing recovery for aiding and abetting would permit plaintiffs to circumvent the reliance element of a Rule 10b-5 claim—a requirement that places "careful limits" on recovery under Rule 10b-5. *Id.* at 180.

Although aiding and abetting liability was a frequently used basis for derivative liability prior to *Central Bank*, since then, consistent with *Central Bank*, courts have declined to imply aiding and abetting liability or other forms of derivative liability. *Central Bank* left open the possibility of aiding and abetting liability to individuals who had been held liable before, such as accountants and attorneys, as primary violators of § 10(b). In *Anixter v. Home-Stake Production Co.*, the Tenth Circuit similarly held that *Central Bank* precludes liability for secondary actors under Section 10(b) unless they "themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors." 77 F.3d 1215, 1226 (10th Cir.1996). "The critical element separating primary from aiding and abetting violations is the existence of a representation, either by statement or by omission, made by the defendant, that is relied upon by the plaintiff. Reliance only on representations made by another cannot itself form the basis of liability. *Id.* at 1225, citing *Central Bank*. Moreover, in *Wright v. Ernst & Young*, 152 F.3d 169, 175 (2d Cir.1998), the Second Circuit stated that "if Central Bank is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter

how substantial that aid may be, it is not enough to trigger liability under Section 10(b)." *Id.* (internal citations omitted).

The Court concludes plaintiffs' claims against Scientific-Atlanta and Motorola are claims for aiding and abetting. Plaintiffs do not assert that Scientific-Atlanta and Motorola made any statement, omission or action at issue or that plaintiffs relied on any statement, omission or action made by either of them. Plaintiffs also do not allege that Scientific-Atlanta or Motorola were responsible for, or were involved with the preparation of Charter's allegedly false or misleading financial statements; Charter's allegedly improper internal accounting practices; or the allegedly false or misleading public statements made by Charter and its former executives. Plaintiffs also do not allege that any of the allegedly misleading statements listed in the amended complaint were made, seen, or reviewed by Scientific-Atlanta or Motorola. Instead, plaintiffs contend that Scientific-Atlanta and Motorola are liable to Charter's investors on the basis that they engaged in a business transaction that Charter purportedly improperly accounted for.

Nor can these defendants be held liable for any purported omissions as plaintiffs have not alleged that Scientific-Atlanta or Motorola had any duty to Charter's investors. *See Chiarella v. United States*, 445 U.S. 222, 235, 100 S.Ct. 1108, 63 L.Ed.2d 348 (1980) (there can be no liability for fraud under Section 10(b) absent a duty to speak). Plaintiffs allege that by virtue of their conduct, Scientific-Atlanta and Motorola made materially misleading statements to Charter investors knowing or recklessly disregarding that such statements were false or misleading. The Court can find no

precedent for the conclusion that business partners, such as Motorola and Scientific-Atlanta, made false and misleading statements by virtue of engaging in a business enterprise with a company such as Charter, the entity purported to have made the statements at issue.

In re Homestore.com Inc. Sec. Litig., 252 F.Supp.2d 1018, 1038 (C.D.Cal.2003), is instructive. In *Homestore* the district court dismissed the complaint, holding that third-party vendors and other business partners were not liable under § 10(b) where plaintiffs failed to allege that they relied on any statements made by those defendants or on the purported "scheme" in which the defendants were alleged to have participated. The *Homestore* court gave three reasons for rejecting plaintiff's theory of liability as to the outside defendants. First, the parties did not cite, nor was the court aware of any case that had ever held a simple business partner to a corporation liable to the shareholders of that corporation for securities fraud. *Id.* at 1037. Second, regardless of how "scheme" is defined, *Central Bank* permits liability only for actors who commit "primary violations" of the securities laws, not "those who merely facilitate or participate." *Id.* at 1038. Third, Homestore shareholders were damaged by reliance on statements and material omissions made by Homestore, not by the "scheme" itself. *Id.* Finally, the court noted that in the cases cited to it following *CentralBank* where an "outsider" had been held liable as a primary violator, the outsider had a special relationship with the corporation, such as accountant or auditor. Thus, these were the kinds of "secondary actors" the Supreme Court in *Central Bank*

foresaw as primary violators. *Id.* at 1039. *Homestore* further stated:

> [T]he language of the Supreme Court does not suggest, and the subsequent case law does not support, the notion that a business partner with no special relationship with a corporation, let alone its shareholders, can be held liable for the material misstatements or omissions of that corporation or its officers, no matter how much it assisted or participated in transactions that led to that statement or omission. Such a holding would broaden the securities acts as to haul into court anyone doing business with a publicly traded company.

Id. at 1039.

Courts have also rejected attempts to characterize such claims as a "scheme to defraud." The *Homestore* court defined a scheme within the meaning of the Exchange Act and the PSLRA as involving "one or more participants acting together to violate securities laws" all of whom "may have varying degrees of culpability depending on their role in the scheme." *Id.* at 1040. Nonetheless *Homestore* held that in light of *Central Bank*, only participants who are primary violators of § 10(b) may be held liable in a private action for securities fraud. *Id.*

Plaintiffs maintain *Homestore* is distinguishable because it involved the actual exchange of services that had real value for the parties regardless of how Homestore treated the

transactions, unlike here where the added price to the transaction had no economic benefit for any of the parties. They further maintain the fact that these defendants did not directly "make" any of the earnings statements issued by Charter does not protect them from liability. Plaintiffs argue that both Scientific-Atlanta and Motorola knowingly or recklessly participated in a fraudulent kickback scheme, the sole purpose of which was to enable Charter, as a valued customer, to inflate its publicly reported revenues and stock price. Therefore, they argue liability for such misconduct falls within Rule 10(b)-(5).

Plaintiffs principally rely on *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F.Supp.2d 549, 577 (S.D.Tex.2002). In *Enron*, plaintiffs claimed Enron's lawyers, accountants and underwriters participated with the company in a "Ponzi" scheme for their own enrichment which, in an essential part of the plan, resulted in defrauding third-party investors in order to keep funds flowing into the company. The complaint specifically claimed that secondary actors caused Enron to violate SEC rules and Generally Accepted Accounting Principles in order to inflate corporate assets, shareholder equity and net income, while at the same time understating company debt.

The *Enron* court found that primary securities fraud allegations were sufficiently stated against several secondary actors, including the company's outside law firm, its auditor and commercial and investment banks. The court adopted the SEC's proposal for primary liability of a secondary party under Rule 10b-5. *Id.* at 590. The SEC proposed, "when a person, acting alone or with others, creates a

misrepresentation [on which the investor-plaintiffs relied], the person can be liable as a primary violator . . . if . . . he acts with the requisite scienter." "Moreover, it would not be necessary for a person to be the initiator of a misrepresentation in order to be a primary violator. Provided that a plaintiff can plead and prove scienter, a person can be a primary violator if he or she writes misrepresentations for inclusion in a document to be given to investors, even if the idea for those misrepresentations came from someone else." Also, "a person who prepares a truthful and complete portion of a document would not be liable as a primary violator for misrepresentations in other portions of the document. Even assuming such a person knew of misrepresentations elsewhere in the document and thus had the requisite scienter, he or she would not have created those misrepresentations." The plaintiff, must of course, plead and prove the elements of scienter and reliance. *Enron*, 235 F.Supp.2d at 583-91 (internal citations omitted.)

Here plaintiffs allege that it was foreseeable to defendants that these transactions would have the intended effect of inflating Charter's revenues and stock price, and as such, defendants knowingly or recklessly engaged in a scheme or artifice designed to defraud Charter investors. Plaintiffs argue this situation is like *Enron* because defendants' alleged kickbacks with Charter had no purpose other than to deceive investors about Charter's true financial condition. The arrangements were meaningful only insofar as they advanced illegitimate ends of an important customer of those defendants.

Appendix D

Scientific-Atlanta and Motorola counter that under *Enron* defendants must have created a misrepresentation upon which investors relied. They argue that they did not create or participate in the creation of Charter's accounting, financial statements, public filings or public statements. They contend that plaintiffs have not alleged that they directed, or even knew of, Charter's accounting treatment. They note that in *Enron* the bank JP Morgan was alleged to have possessed non-public financial information about Enron that would have demonstrated that the transactions in which it was involved were fraudulent. They further note that here plaintiffs have not alleged, nor can they allege that these defendants possessed any non-public information about Charter's financials or its accounting practices, and that these defendants had the ability to verify the accuracy of Charter's public statements. Scientific-Atlanta and Motorola also contend they made no public representations about Charter and that no Charter investor relied on anything they said. Finally, they note that other third parties who transacted business with Enron, such as the law firm of Kirkland & Ellis, as well as Lehman Brothers and Bank of America, were dismissed for failure to state a claim.

This Court does not find *Enron* on point. To reiterate, *Enron* held that § 10(b) liability may only be imposed for secondary actors who have created a document containing a misrepresentation upon which investors relied. The Amended Complaint does not allege that Scientific-Atlanta or Motorola created or participated in the creation of any of Charter's accounting, financial statements, public filings or public statements, nor does it allege that they directed, or even knew of, Charter's accounting treatment. The plaintiffs also do not

allege Scientific-Atlanta and Motorola made public representations about Charter or that any Charter investor relied on anything Scientific-Atlanta and Motorola said. The Court concludes that plaintiffs' claim fails as neither Scientific-Atlanta nor Motorola made a representation to Charter's investors nor participated in the drafting of statements Charter made to its investors.

The Court concludes for the above reasons that plaintiffs' claims against defendants Scientific-Atlanta and Motorola are barred by *Central Bank of Denver. N.A. v. First Interstate Bank of Denver, N.A.*, The parties have not provided, nor has the Court found, any precedent holding a business partner to a corporation, such as Scientific-Atlanta and Motorola here, liable to the investors of that corporation for securities fraud. As the Court finds that plaintiffs' claims are precluded as to Scientific-Atlanta and Motorola as a matter of law, the Court need not address the sufficiency of the Amended Complaint as to these defendants.

C. Arthur Andersen, LLP

Arthur Andersen, LLP ("Andersen"), Charter's outside auditor during the Class Period, moves to dismiss Count IV of the Amended Complaint for failure to state a claim. The PSLRA's pleading requirements do not distinguish between corporate defendants and accountants. Therefore, although the factual allegations against Andersen in the Amended Complaint must be separately considered, the pleading principles set forth above apply equally to the allegations against an accounting firm such as Andersen. *In re MicroStrategy, Inc. Sec. Litig.*, 115 F.Supp.2d 620, 650

(E.D.Va.2000). After reviewing the Amended Complaint and drawing all inferences in favor of plaintiffs as the Court must do in reviewing a motion to dismiss, the Court finds that the plaintiffs have satisfied the heightened pleading standards of the PSLRA.

"Scienter means the intent to deceive, manipulate, or defraud." *Green Tree*, 270 F.3d at 653 (internal quotations omitted). Although the Reform Act's heightened pleading rules require a showing of a "strong inference" of scienter, Congress did not codify any particular methods of satisfying that requirement. *Kushner v. Beverly Enters.*, 317 F.3d 820, 827 (8th Cir.2003). The Eighth Circuit holds that the Reform Act was not intended to alter the substantive nature of the scienter requirement, and therefore its prior case law on the issue remains instructive for this Court. *Green Tree*, 270 F.3d at 653 & n. 7.

As a general rule, inferences of scienter tested under the Reform Act will not survive a motion to dismiss if they are only reasonable inferences-the inferences must be " 'both reasonable and strong.' *"Helwig v. Vencor, Inc.*, 251 F.3d 540, 551 (6th Cir.2001) (en banc) (quoting *Greebel*, 194 F.3d at 195-96), *cert. dismissed*, 536 U.S. 935, 122 S.Ct. 2616, 153 L.Ed.2d 800 (2002). Other circuit case law suggests that a strong inference of the required scienter may arise where the complaint sufficiently alleges that the defendants (1) benefitted in a concrete and personal way from the purported fraud, (2) engaged in deliberately illegal behavior, (3) knew facts or had access to information suggesting that their public statements were not accurate, or (4) failed to check information they had a duty to monitor.

See Kushner, 317 F.3d at 827, citing *Novak v. Kasaks*, 216 F.3d 300, 311 (2d Cir.), *cert. denied*, 531 U.S. 1012, 121 S.Ct. 567, 148 L.Ed.2d 486 (2000). The Eighth Circuit considers how other circuits have interpreted the strong-inference-of-scienter language as valuable guidance about what factors help to establish such an inference, but takes care to use subsidiary formulae as an aid to interpreting the strong-inference standard and not as a substitute for it. *Navarre*, 299 F.3d at 746 (internal quotations omitted).

Scienter may also be demonstrated by recklessness. *Kushner*, 317 F.3d at 828; *Green Tree*, 270 F.3d at 653. Scienter may be established by severe recklessness involving "highly unreasonable omissions or misrepresentations" amounting to "an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it." *K & S P'ship v. Cont'l Bank, N.A.*, 952 F.2d 971, 978 (8th Cir.1991) (internal quotations omitted), *cert. denied*, 505 U.S. 1205, 112 S.Ct. 2993, 120 L.Ed.2d 870 (1992). Recklessness, then, may be shown where unreasonable statements are made and the danger of misleading plaintiffs is so obvious that the defendant must have been aware of it. *Id.* "[S]ecurities fraud claims typically have sufficed to state a claim based on recklessness when they have specifically alleged defendants' knowledge of facts or access to information contradicting their public statements." *Novak*, 216 F.3d at 308. Also, recklessness is shown where alleged facts demonstrate that the defendants failed to review or check information that they had a duty to monitor, or ignored obvious signs of fraud. *Id.*

Appendix D

According to the Amended Complaint, Andersen served as Charter's independent auditors throughout the Class Period. In that capacity, Andersen performed audits of Charter's books, records, and financial statements for the years 1999, 2000, and 2001. Plaintiffs allege that Andersen violated § 10(b) and Rule 10b-5 in auditing the financial statements prepared by Charter.

Plaintiffs allege that as Charter's auditor, Andersen had full access to its books, records and personnel, and knew, or recklessly disregarded, that (a) Charter's capitalization rate was the highest in the industry, and resulted from Charter's improper capitalization of costs that should have been expensed; (b) Charter had a pattern of holding disconnects, which contributed to a significant rise in account receivables that should have been promptly written off; (c) Charter improperly accounted for other matters, such as including all launch fees paid by program providers at the initial rate of a contract, rather than over the entire term of the contract; and (d) though aware that Charter was seeking to boost its revenues by paying vendors higher prices at the same time it received additional advertising from the same vendors, Andersen failed to properly audit these transactions by confirming them with the vendors. (Amended Complaint at ¶ 193.)

Plaintiffs specifically allege that following such audits, Andersen issued opinion letters stating that its audits of Charter's financial statements had been conducted in conformance with Generally Accepted Auditing Standards

("GAAS"),[2] and that the statements conformed with Generally Accepted Accounting Principles ("GAAP").[3] (*Id.* at ¶ 191.) Andersen issued a "Report of Independent Public Accountants" with respect to Charter's financial statements for the years 1999, 2000, and 2001 in which Andersen stated that it had conducted its audits in accordance with GAAS and that Charter's financial statements were fairly presented in conformity with GAAP. (*Id.* at ¶¶ 100, 113, 138, 191.) Plaintiffs asserts that Andersen's statements about GAAP and GAAS were false and misleading (*Id.* at ¶¶ 95, 192), resulting in major financial restatements for 2000 and 2001. (*Id.* at ¶¶ 154-55.)

On April 2, 2003, Charter announced its "preliminary" restatement of reported results for 2000 and 2001, as well as the first three quarters of 2002. Charter acknowledged for the first time that its "operating cash flow," otherwise known as earnings before interest, taxes, depreciation and amortization ("EBITDA"), had been inflated by 19.5% ($292 million) for the year 2001, and by 14.5% ($195 million) for

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2. GAAS are the standards prescribed by the Auditing Standards Board of the American Institute of Certified Public Accountants for the conduct of auditors in the performance of an examination. *See In re Ikon Office Solutions, Inc.*, 277 F.3d 658, 663 (8th Cir.2002), cited in *SEC v. Arthur Young & Co.*, 590 F.2d 785, 788 n. 2 (9th Cir.1979).

3. GAAP is "a technical accounting term that encompasses the conventions, rules, and procedures necessary to define accepted accounting practices at a particular time." See American Institute of Certified Public Accounts ("AICPA"), Statement of Auditing Standards No. 69, ¶ 69.02 (1992), quoted in *Sanders v. Jackson*, 209 F.3d 998, 1001 n. 3 (7th Cir.2000).

the year 2000. Most significantly, Charter acknowledged for the first time that whereas it had previously reported operating cash flow had grown 12.5% during 2001 compared to 2000, in fact, such growth had been only half that amount. (*Id.* at ¶ 15.)

Given the significance assigned operating cash flow, it was critically important whether a company expensed certain costs, or capitalized them over a period of time (in which case they were excluded from operating cash flow). (*Id.* at ¶ 43.) GAAP governs the accounting for such costs and the determination of whether they are expensed or capitalized.

Plaintiffs assert Andersen knew or recklessly ignored Charter's significant GAAP violations. They allege that while Charter's stated policy[4] conformed to GAAP, in actual

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4. Charter's *stated* accounting policy for expenses conformed to GAAP. The *stated* policy was:

> Costs capitalized as part of new *customer installations* include materials, subcontractors costs, internal direct labor costs, including service technicians and customer care representatives and internal overhead costs incurred to connect the customer to the plant from the time of installation scheduling through the time service is activated and functioning. We capitalize incremental and direct contract acquisition costs to the extent realizable from future revenues. The overhead rates established are based on a combination of internal company-wide overhead analysis and internal time and motion studies of specific activities. These studies are updated to adjust for changes in facts and circumstances. . . . The *costs of disconnecting and reconnecting* a customer are charged

(Cont'd)

practice, Charter consistently violated its own policy and GAAP by arbitrarily capitalizing material portions of certain labor related expenses in order to artificially enhance its operating cash flow results to be in line with Wall Street's expectations. This dovetailed with Charter's fraudulent inflation of its internal customer growth rate previously described. (*Id.* at ¶ 46.)

Plaintiffs assert the favorable, though fraudulent, results that Charter disseminated during the Class Period were intended to enable Charter to meet analysts' forecasts and thereby bolster the price of Charter stock. In turn, this enabled Charter to continue to use its stock as valuable currency on its acquisition spree, completing sixteen acquisitions in the years 1999 and 2000 alone. (*Id.* at ¶ 47.)

Plaintiffs assert senior Charter executives orchestrated a scheme to artificially inflate the number of Charter cable TV subscribers and misstate Charter's earnings by inflating Charter's operating cash flow. (*Id.* at ¶¶ 3- 9, 48-59, 62, 72-73, 83-94.) On the directives of corporate officers, Charter capitalized numerous labor costs that should have been expensed. (*Id.* at ¶ 62.) This widespread practice not only

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(Cont'd)

> to expense in the period incurred. *Expenditures for repairs and maintenance* are charged to operating expense as incurred, while equipment replacements and betterments, including the replacement of drops, are capitalized. (Emphasis in Amended Complaint.)

(*Id.* at ¶ 45.)

violated GAAP, Financial Accounting Standard 51,[5] ("FAS") but was inconsistent with Charter's own policy as set forth in its public filings, particularly with respect to repair and disconnection related expenses. (*Id.* at ¶ 63.) Charter also

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5. Financial Accounting Standard ("FAS") 51 governs the standards for accounting on specific issues related to the cable industry. Among other things, FAS 51 states:

> a. Labor costs associated with installing new services on the *first visit* to an address can be capitalized, and then depreciated over a period no longer than the period used to depreciate the cable television plant.
>
> b. A portion of associated "indirect" costs, that are associated with installation or upgrade labor costs may likewise be capitalized.
>
> c. The costs of subsequently disconnecting or reconnecting a subscriber (or an address) must be expensed. Thus, the second time a service is enabled at an address (even if it is a new subscriber), it must be expensed in the period incurred.
>
> d. "Subscriber related costs" and general administration expenses must be expensed in the period incurred. These costs include:
>
> > Cost of billing and collection, bad debts, mailings, repairs and maintenance of taps and connections, general and administrative systems costs such as salary of the system manager and office rent, programming costs for additional channels used in the marketing effort or costs related to revenues from per channel or per program service, and direct selling costs.

(*Id.* at ¶ 44.)

routinely capitalized significant portions of "reconnect" costs (costs to reconnect subscribers who had requested that their cable be disconnected or whose service had been terminated for failure to pay their bills). (*Id.* at ¶ 64(d).) As a result, plaintiffs assert Charter improperly capitalized costs totaling $93 million in 2001, and $52 million in 2000. (*Id.* at ¶ 64(e).)

Plaintiffs further assert Charter paid third-party contractors to conduct marketing campaigns and then improperly deferred the costs of those services rather than expensing them as incurred. (*Id.* at ¶ 64(h).) This practice was in direct violation of Statement of Position 93-7[6] ("SOP" 93-7), Reporting on Advertising Costs, which governs the accounting for advertising costs under GAAP. As a result, during 2001, $59 million in marketing campaign expenses were improperly deferred rather than expensed. (*Id.*)

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6. SOP 93-7 states the following:

> The costs of advertising should be expensed either as incurred or the first time advertising takes place except for:
>
> a. Direct-response advertising (1) whose primary purpose is to elicit sales to customers who could be shown to have responded specifically to the advertising and (2) that results in probable future economic benefits (future benefits). Examples of the first time advertising takes place include the first public showing of a television commercial for its intended purpose and the first appearance of a magazine advertisement for its intended purpose.
>
> b. Expenditures for advertising costs that are made subsequent to recognizing revenues related to those costs.

Appendix D

Referring to the alleged sham arrangements with vendors Scientific-Atlanta and Motorola intended to artificially boost Charter's revenues and operating cash flow, the plaintiffs allege that indicative of the deliberately fraudulent nature of these transactions, Kent Kalkwarf "discussed the concept" with Arthur Andersen in August 2000, prior to any payments being exchanged. At the time Andersen stated that "Charter could not recognize the advertising payments as revenue because they appeared integrally related to the cost increases being paid by Charter." (*Id.* at ¶ 80.) Andersen advised Charter that it could recognize the advertising fees as revenues if the additional payments for the converter boxes and the advertising were (1) at fair market value; (2) unrelated to one another; and (3) negotiated at least one month apart.

In late August 2000, Kalkwarf advised Andersen that it would fulfill those conditions. In September 2000, Kalkwarf falsely told Andersen that the advertising and supply contracts with Scientific-Atlanta and Motorola had been negotiated by two separate departments at Charter, one month apart from each other. Plaintiffs allege that to lend further credibility to these claims, even though the set-top box price increases were not finalized with either vendor until late September 2000, the contracts were backdated to August 2000 on the instructions of Kalkwarf and David Barford, to give the false appearance that the set-top box price agreements were negotiated a month before the advertising contracts which were dated in late September. (*Id.* at ¶ 80.)

Despite being aware that Charter was seeking to generate additional revenue through a series of questionable transactions with these two vendors, Andersen accepted the

explanations provided by Kalkwarf and Barford, and failed to perform further audit checks, for example, requesting additional verification from the vendors as required under GAAS. (*Id.* at ¶ 81.)

In support of its motion, Andersen argues the Amended Complaint fails to allege facts sufficient to establish the required strong inference of scienter necessary to state a claim of securities fraud. Specifically, Andersen argues the Amended Complaint contains few allegations about Andersen and fails to establish Andersen acted with fraudulent intent. Andersen argues that the Amended Complaint largely addresses Charter's alleged conduct in calculating the number of its cable TV subscribers. Andersen notes that there is no allegation it approved or "certified" the subscriber count number in any way, nor could there be, because Andersen merely audited Charter's financial statements, which did not reference the subscriber count. Andersen argues the Amended Complaint fails to allege specific facts to support the conclusion that Andersen—at the time of the audits—knew of or recklessly disregarded GAAP and GAAS violations, or to suggest Andersen acted fraudulently or recklessly at the time it audited the financial statements. Andersen contends the allegation that it had "full access" to Charter's books, records and personnel, as well as plaintiffs' allegations as to GAAP and GAAS, are insufficient to establish the requisite strong inference of scienter under § 10(b).

Plaintiffs oppose the motion, asserting the Amended Complaint pleads numerous facts that, taken together, give rise to the requisite strong inference of scienter. They note that the magnitude of the fraud, involving improper

accounting for $487 million of Charter's revenues and expenses, and inflation of Charter's growth rate for operating cash flow by 100%, strongly suggests that Andersen was either a knowing or severely reckless participant in the fraud. They argue that Andersen disregarded numerous "red flags" which should have alerted it to Charter's fraud, including Charter's unusually high capitalization rate; its practice of including all new program launch fees paid by program providers at the initial date of a contract period, rather than amortizing these fees over the entire term of a contract; and its ignoring the series of sham transactions that Charter conducted with its two main digital converter-box providers in an effort to boost operating cash flow. Plaintiffs claim Andersen knew of Charter's deceptive purpose for these transactions, but did nothing to investigate them further as required by GAAS, noting that a Charter official discussed the propriety of booking revenues on the wash transactions with Andersen, who advised that Charter's plan would violate GAAP unless certain specific conditions were met. Despite being on notice of the true purpose of these transactions, as well as their presumptive illegitimacy, Andersen failed to make basic inquiries, such as requesting additional verification from the vendors when Charter represented that Andersen's conditions had been met.

Plaintiffs contend the magnitude of the GAAP violations, and the inference of scienter to be drawn therefrom, is confirmed by Charter's restatement after Andersen was replaced as auditor. Given the severity of the GAAP violations, Charter was forced to restate its 2000 and 2001 financials. For 2000, this resulted in reduced revenues of $108 million and increased expenses of $87 million. For

2001, this resulted in reduced revenues of $146 million and increased expenses by $146 million. Plaintiffs note that as a result, Charter's reported growth rate for 2001 was reduced by one half. The plaintiffs argue that these sums are not reasonable differences over interpretation and application of GAAP, but speak of a massive and concerted fraud that only the most callous auditor could fail to detect. (*Id.* at ¶¶ 43-44, 60-71, 75-82.)

The plaintiffs assert the combination of GAAP violations, red flags, and the financial restatement satisfy the scienter requirement. The Court agrees. Allegations of GAAP violations, alone, are insufficient to state a claim for securities fraud. *Navarre*, 299 F.3d at 745. However, GAAP violations coupled with evidence of corresponding fraudulent intent may state a securities fraud claim. *In re K-Tel Int'l, Inc.*, 300 F.3d 881, 894 (8th Cir.2002); *see also In re McKesson HBOC, Inc. Sec. Litig.*, 126 F.Supp.2d 1248, 1272 (N.D.Cal.2000) ("when significant GAAP violations are described with particularity in the complaint, they may provide powerful indirect evidence of scienter").

Plaintiffs allege Andersen knew or recklessly ignored Charter's significant GAAP violations, particularly noting Charter's operating cash flow rate growth rate, which was reported to be twice the actual operating cash flow growth rate. They allege the inflated results were achieved by accounting ploys such as the capitalization of labor costs that should have been expensed, as well as the recognition of non-existent revenues from sham transactions with Scientific-Atlanta and Motorola. They allege this practice not only violated GAAP and FAS 51, but was inconsistent

with Charter's own policy as set forth in its public filings, particularly the portion related to repair and disconnection related expenses. The plaintiffs allege Charter routinely but improperly capitalized significant portions of "reconnect costs," resulting in improperly capitalized costs totaling $93 million in 2001 and $52 million in 2000. Plaintiffs further argue Andersen knew or recklessly ignored Charter's significant GAAP violations, citing Charter's inflated operating cash flow as the linchpin of Charter's fraud. They note that whereas Charter reported that operating cash flow grew at 12-14% during the Class Period, its actual operating cash flow growth rate was only 6%.

Plaintiffs also allege Charter paid third-party contractors to conduct marketing campaigns and then improperly deferred the costs of those services rather than expensing them as incurred, in violation of SOP 93-7, Reporting on Advertising Costs, which governs the accounting for advertising costs under GAAP. As a result, the plaintiffs allege $59 million in marketing campaign expenses were improperly deferred rather then expensed in 2001.

Plaintiffs assert Andersen either knowingly or recklessly ignored several "red flags" in acquiescing to these violations. Courts have held allegations an auditor ignored "red flags" is probative of fraudulent intent or recklessness. *See e.g.*, *In re Health Mgmt. Inc. Sec. Litig.*, 970 F.Supp. 192, 203 (E.D.N.Y.1997); *In re Oxford Health Plans, Inc. Sec. Litig.*, 51 F.Supp.2d 290, 295-96 (S.D.N.Y.1999). This is a matter of degree, however, the probative value of allegations that an auditor ignored "red flags" is a function of the nature and number of such flags. *In re MicroStrategy*, 115 F.Supp.2d at

653-54. Thus, as one court stated, "while [defendant's] ignorance of warning signs in one sense demonstrate[s] that it was merely negligent, allegations that, with gross recklessness, [defendant] ignored multiple 'red flags' could reasonably support an inference that [defendant] acted with intent." *In re Leslie Fay Cos., Inc.*, 871 F.Supp. 686, 699 (S.D.N.Y.1995) (holding that an accountant's ignoring multiple "red flags" could reasonably support an inference that the accountant defendant acted with intent).

The first red flag plaintiffs note was Charter's "extraordinary" capitalization rate, which plaintiffs allege was by far the highest in the industry. They note that Charter's aggressive capitalization policy was one of the factors Merrill Lynch cited in deciding to downgrade its investment rating from "strong" to "neutral." The plaintiffs note that Merrill Lynch's ability to ascertain this indicator of Charter's troubles—without the benefit of the extensive access to Charter's books that Andersen enjoyed—is additional evidence of Andersen's recklessness. Plaintiffs maintain another red flag was Charter's practice of including all new program "launch fees" paid by program providers at the initial date of a contract period rather than amortizing them over the entire term of the contract.

Plaintiffs assert a third red flag was Charter's ignoring a series of sham transactions that Charter conducted with two vendors, Scientific-Atlanta and Motorola, in an attempt to boost operating cash flow. The plaintiffs allege that despite being on notice of the true purpose of these transactions, as well as their presumptive illegitimacy, Andersen failed to make basic inquiries, such as requesting additional

verification from vendors, when Charter represented that Andersen's conditions had been satisfied.

As previously stated, plaintiffs maintain Charter's significant financial restatement after Andersen was re-placed as auditor provides further inference of scienter. On April 2, 2003, Charter announced its "preliminary" restatement of reported results for 2000 and 2001, as well as the first three quarters of 2002. Charter acknowledged for the first time that its "operating cash flow" had been inflated by 19.5% ($292 million) for the year 2001, and by 14.5% ($195 million) for the year 2000. Most significantly, Charter acknowledged for the first time that whereas it had previously reported operating cash flow had grown 12.5% during 2001 compared to 2000, in fact, such growth had been only half that amount. (*Id.* at ¶ 15.) The plaintiffs allege these large figures suggest a massive and concerted fraud, not merely reasonable differences over interpretation and application of GAAP.

"The mere *fact* that there was a restatement or a violation of GAAP, by itself, cannot give rise to a strong inference of scienter; the *nature* of such a restatement or violation, however, may ultimately do so." *In re MicroStrategy*, 115 F.Supp.2d at 635. "Common sense and logic dictate that the greater the magnitude of a restatement or violation of GAAP, the more likely it is that such a restatement or violation was made consciously or recklessly." *Id.* at 636. The Court agrees that the size of the restatement here is probative of a strong inference of scienter on the part of Andersen.

The plaintiffs finally argue that Andersen's knowledge of Charter's operations also supports a strong inference of

scienter. They note that throughout the relevant time period, Andersen had full access to Charter's books and revenues. The allegations that Andersen had knowledge of Charter's operations in and of itself is not probative of scienter. It does not necessarily follow that because Andersen had access to Charter's operations it was aware of the alleged fraud at Charter, but it is also true that the greater access Andersen's access to Charter operations, the greater the possibility of an inference of scienter. *See In re MicroStrategy*, 115 F.Supp.2d at 653.

This Court finds plaintiffs' allegations concerning Andersen's failure to detect Charter's purported fraud amount to an "egregious refusal to see the obvious, or to investigate the doubtful," thus creating a strong inference of scienter. *See Homestore*, 252 F.Supp.2d 1043. The Court finds these allegations, considered alone, would not be sufficient to raise a strong inference of scienter. However, the allegations do not exist in isolation. Taken together, the allegations provide important information on the context in which Andersen may have conducted its audits of Charter's financials, and therefore, this information is relevant to weighing the strength of any scienter inference.

Considering the Amended Complaint and drawing all inferences in favor of plaintiffs as is required in reviewing a motion to dismiss, the Court finds that the plaintiffs have established the heightened pleading requirements of the PSLRA. The Court concludes the Amended Complaint's allegations as to Andersen's GAAS violations, Charter's GAAP violations and subsequent financial restatements, Andersen's level of access to Charter and necessary

knowledge of its operations and most important contracts, and the existence of circumstances suggesting that Andersen was or should have been aware of Charter's accounting practices, taken in context and in light of the totality of the circumstances, raise a strong inference that Andersen acted with scienter. *Cf. Danis v. USN Communications, Inc.*, 73 F.Supp.2d 923 (N.D.Ill.1999) (plaintiffs satisfied pleading requirements under PSLRA where complaint alleged auditor/consultant violated GAAS, had sufficient contact with the company to become aware of fraudulent abuses, as well as pervasive and fundamental internal control problems at company; court noted auditor was hired to consult, and did not simply allege auditor had access to information); *In re Cendant Corp. Sec. Litig.*, 60 F.Supp.2d 354, 372-73 (D.N.J.1999) (denied accounting firm's motion to dismiss where plaintiffs alleged operating income was overstated, earnings per share were overstated, audits were not performed in accordance with GAAS, and quarterly financial statements were materially false and misleading). Accordingly, Andersen's motion to dismiss should be denied.

D. Settling Parties' Joint Motion for a Protective Order

Finally, also before the Court is a joint motion for a protective order filed by Charter and plaintiffs. As previously stated, plaintiffs, Charter, and the individual defendants state that they have reached a tentative settlement. They also state that they have entered into a Memorandum of Understanding ("MOU"). The MOU contemplates Charter's voluntary commitment to make a limited number of mutually agreed-upon witnesses under its control available for interviews or meetings with plaintiffs, and to provide plaintiffs with requested documents as necessary to facilitate due diligence

concerning the fairness of the proposed settlement. The Proposed Protective Order ("PPO") applies only to these voluntary disclosures made by Charter. The PPO further provides that, after the plaintiff's due diligence is completed, plaintiffs "shall retain the right to utilize the documents produced [by Charter] in accordance with this Order solely to litigate its existing claims against the non-settling defendants in this action." ¶ 18.

Anderson, the remaining defendant which is not a party to the tentative settlement, objects to provisions of the PPO.[7] Andersen argues that due to the pendency of its motion to dismiss, a stay of discovery already exists pursuant to the Reform Act, and thus, plaintiffs are not permitted any discovery relevant to the claims against it unless and until plaintiffs demonstrate they have sufficiently stated a claim under the Reform Act. Thus, Andersen seeks to prohibit the use of documents received by plaintiffs that would interfere with or undercut the protections afforded to it under the Reform Act. Andersen argues plaintiffs' claims against it be based on the allegations in the Amended Complaint and that any documents obtained by plaintiffs not be used for purposes of responding to the pending motions to dismiss and for drafting a second amended complaint in response to a ruling sustaining the motions to dismiss.

Andersen further argues that the Federal Rules do not authorize its exclusion from discovery conducted under the auspices of the Court. Andersen argues alternatively that even

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7. Scientific-Atlanta and Motorola also opposed the PPO. Their arguments are moot in light of the Court's ruling on their motions to dismiss.

if the Federal Rules do not obligate the Court to reject their PPO, fundamental fairness and efficiency require that they be given simultaneous access to the information Charter provides. Andersen also seeks the opportunity to monitor the ongoing discovery between the settling parties, including being provided access to whatever documents are made available to plaintiffs, as well as notice and an opportunity to attend the interviews at its expense.

Charter responds that Andersen has failed to demonstrate it has a right to participate in this informal exchange of information. As an accommodation, Charter states it will provide Andersen with access to the documents given, but will not permit it to attend the informal interviews contemplated by the MOU. Charter asserts that the contemplated interviews are part of a voluntary exchange of information in furtherance of settlement, not depositions compelled by the Federal Rules or court process, and thus are outside the ambit of formal discovery governed by the Federal Rules and the Reform Act. Charter further maintains Andersen will suffer no prejudice as a result of being denied access to the interviews given that the interviews constitute inadmissible out of court statements that cannot be used by any other party not in attendance.

The purpose of the Reform Act was "to restrict abuses in securities class-action litigation, including: (1) the practice of filing lawsuits against issuers of securities in response to any significant change in stock price, regardless of defendants' culpability; (2) the targeting of "deep pocket" defendants; (3) the abuse of the discovery process to coerce settlement; and (4) manipulation of clients by class action

attorneys." *SG Cowed Sec. Corp. v. United States District Court for the Northern District of California*, 189 F.3d 909, 911 (9th Cir.1999) (quoting *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 530-31 (3d Cir.1999)). The Reform Act "mandated a stay of discovery during the pendency of a summary judgment or dismissal motion." *Id.* Under the Reform Act, "all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party." 15 U.S.C. § 78u-4(b)(3)(B). The stay provision was "intended to prevent unnecessary imposition of discovery costs on defendants." *SG Cowed*, 189 F.3d at 911 (citing H.R. Conf. Rep. No. 104-369, 104th Cong. 1st Sess. at 32 (1995), reprinted in 1995 U.S.C.C.A.N. Sess. 731).

The Court concludes Andersen has been afforded the protections of the Reform Act's stay provision. The Court further concludes Andersen's concern regarding the protections of stay provision is moot based on the Court's ruling that plaintiffs have sufficiently stated a claim under the Reform Act.

The Court further concludes Andersen has not demonstrated it has a right to participate in the exchange of information between the settling parties. The contemplated interviews or informal discovery are with individuals under Charter's control, not Andersen representatives, and are part of a voluntary exchange of information in furtherance of settlement, not depositions compelled by the Federal Rules or court process.

Appendix D

The parties have not provided any case authority that is factually analogous to the situation at hand, nor is the Court aware of any. In *JDS Uniphase Corp. Sec. Litig.*, 238 F.Supp2d 1127 (N.D.Cal.2002), the plaintiffs sought a court order allowing defendant's former employees to speak voluntarily to plaintiffs' lead counsel about certain topics without fear of breaching their former employer's confidentiality agreements. No motion to dismiss was pending. The court held that it was not discovery under the Federal Rules, because the plaintiffs were not using court process to require these third parties to provide information about the lawsuit, but were merely seeking an order that would allow former employees to speak voluntarily if they wished to do so. The court held that unlike discovery and initial disclosures, the interviews were not compelled by the Federal Rules. Neither the former employees nor the defendants were required to participate in these interviews in any way. *Id.* at 1134. The court reiterated that "the Reform Act was not intended to provide defendants with immunity from suit, but, rather, was intended to protect defendants from the burdens of defending against frivolous litigation." *Id.* at 1134. *Cf. In re Tyco Int'l Ltd. Sec. Litig.*, 2001 U.S. Dist. Lexis 819 (D.N.H.2001) (district court declined to prohibit voluntary discussions between plaintiffs and third party witnesses, stating "[n]either logic, tradition, the constitution nor the PSLRA prohibit interviewing prospective witnesses"); *Maley v. Del Global Techs. Corp.*, 186 F.Supp.2d 358, 363-64 (S.D.N.Y.2002) (securities fraud class action submitted proposed settlement for approval to district court; settlement was fair despite lack of formal discovery based in part on "confirmatory" discovery, including production of documents, interviews with senior officials, and inspection

of company's facilities); *Connecticut Gen. Life Ins. Co. v. Connecticut Gen. Life Ins. Co.*, M.D.L. 1156, No. CV 95-3566, 1997 WL 910387 (C.D.Cal. Feb.13, 1997) (parties sought certification of the settlement class and final judgment approving the settlement; permitting informal confirmatory discovery to verify certain facts provided during settlement negotiations.)

The Court believes Andersen will suffer no prejudice by not being permitted to attend the informal interviews contemplated by the MOU in light of the fact that it will be provided access to the documents that will be provided to plaintiffs. Therefore, the Court will grant the joint motion for a protective order and will enter the PPO as submitted by the parties to the tentative settlement. Charter and plaintiffs will provide Andersen access to the documents provided by Charter as long as Andersen agrees to be bound to the terms of the Protective Order.

III. CONCLUSION

For the above reasons, the Court concludes that plaintiffs' claims against defendants Scientific-Atlanta and Motorola are barred by *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191, 114 S.Ct. 1439, 128 L.Ed.2d 119 (1994), and accordingly, the Court will grant their motions to dismiss the Amended Complaint. The Court also concludes plaintiffs have satisfied their pleading burden under the PSLRA to maintain their claims against Arthur Andersen. Therefore, the Court will deny Andersen's motion to dismiss. The Court will grant the joint motion for a protective order and will enter the PPO as submitted by the parties to the tentative settlement. Accordingly,

Appendix D

IT IS HEREBY ORDERED that the stay in this action is lifted.

IT IS FURTHER ORDERED that Scientific-Atlanta, Inc.'s motion to dismiss Count V of plaintiffs' amended consolidated class action complaint is **GRANTED**. (Doc. 133)

IT IS FURTHER ORDERED that Motorola, Inc.'s motion to dismiss Count V of plaintiffs' amended consolidated class action complaint is **GRANTED**. (Doc. 150)

IT IS FURTHER ORDERED that Motorola, Inc.'s motion for a hearing on its motion to dismiss is **DENIED**. (Doc. 212)

IT IS FURTHER ORDERED that Arthur Andersen's motion to dismiss Count IV of the amended consolidated class action complaint is **DENIED**. (Doc. 138.)

IT IS FURTHER ORDERED that the Joint Motion for a Protective Order is **GRANTED**. (Doc. 242.)

IT IS FURTHER ORDERED that Arthur Andersen's Motion for Leave to File a Surreply Regarding the Joint Motion for a Protective Order is **DENIED**. (Doc. 250.)

Appendix D

IT IS FURTHER ORDERED that Scientific-Atlanta's Motion for leave to Submit a Supplemental Memorandum Regarding the Joint Motion for a Protective Order is **DENIED**. (Doc. 251.)

s/ Charles A. Shaw
CHARLES A. SHAW
UNITED STATES DISTRICT JUDGE

Dated this 12th day of October, 2004.